Pros and Cons of Filing a Chapter 7 for a Business Entity and Alternatives (ABC, Receiverships, etc.)

The Inland Empire Bankruptcy Forum Presents a Zoom Webinar

with the support of the Orange County Bankruptcy Forum

and the Central District Consumer Bankruptcy Attorney Association

Panelists:
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Howard Grobstein, Grobstein Teeple
Misty Perry-Isaacson, Pagter & Perry-Isaacson

Moderator:
Richard Marshack, Marshack Hays LLP

Date/Time:
Wednesday, Feb. 3, 2021 at 5:00pm

California Bankruptcy Forum
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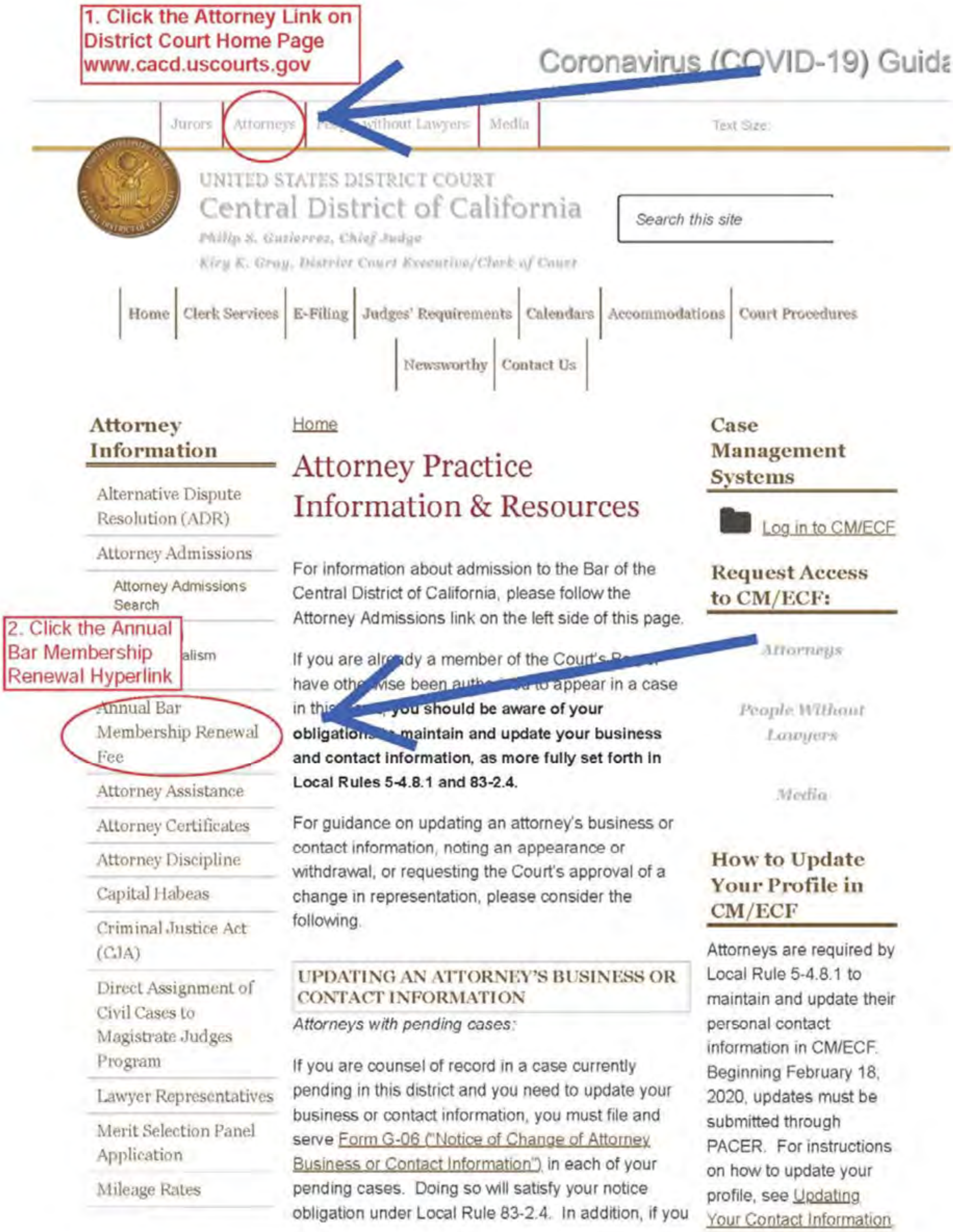

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On May 28, 2020, the United States District Court for the Central District of California issued General Order No. 20-07, which instituted an annual renewal fee of $25 for all members of this Court's Bar. See General Order No. 20-07, available at www.cacd.uscourts.gov/court-procedures/general-orders. Beginning in 2020, this annual renewal fee of $25 is due on September 1 of each year for all attorneys admitted to the Court's bar before September 1 of the prior year. Click the button below to pay the fee online.

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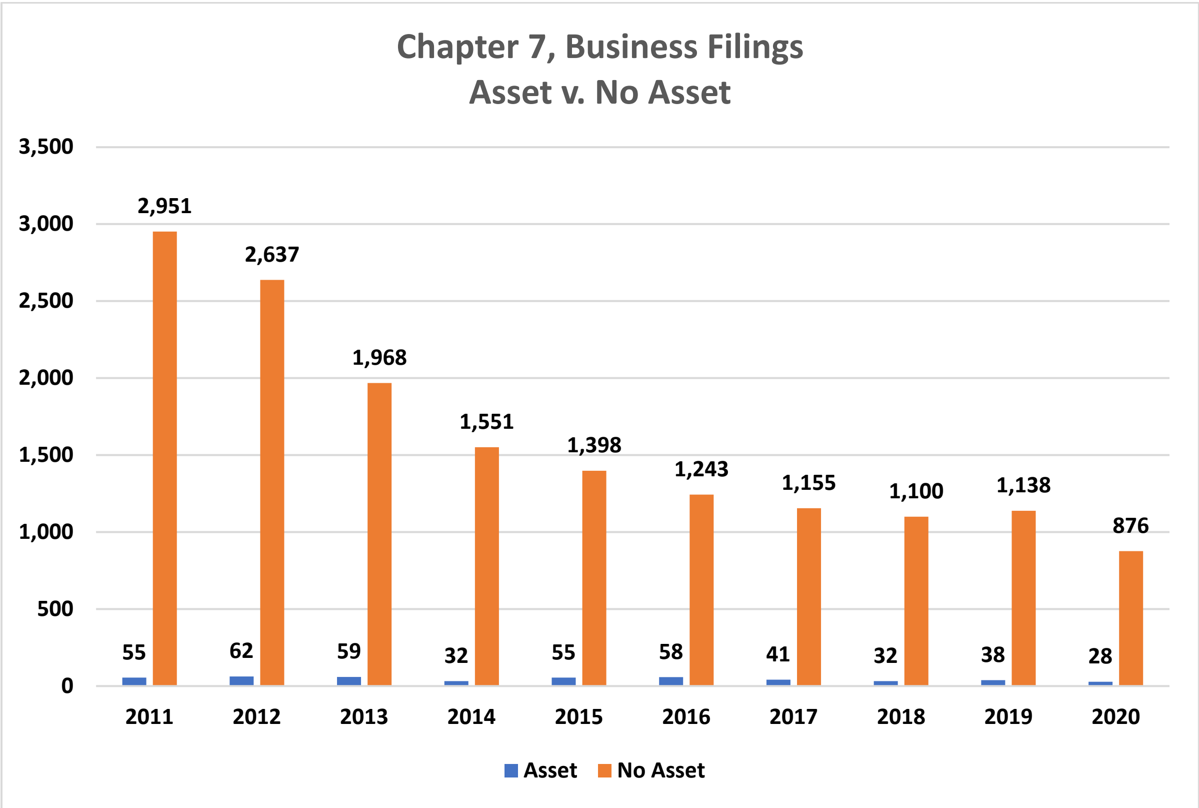
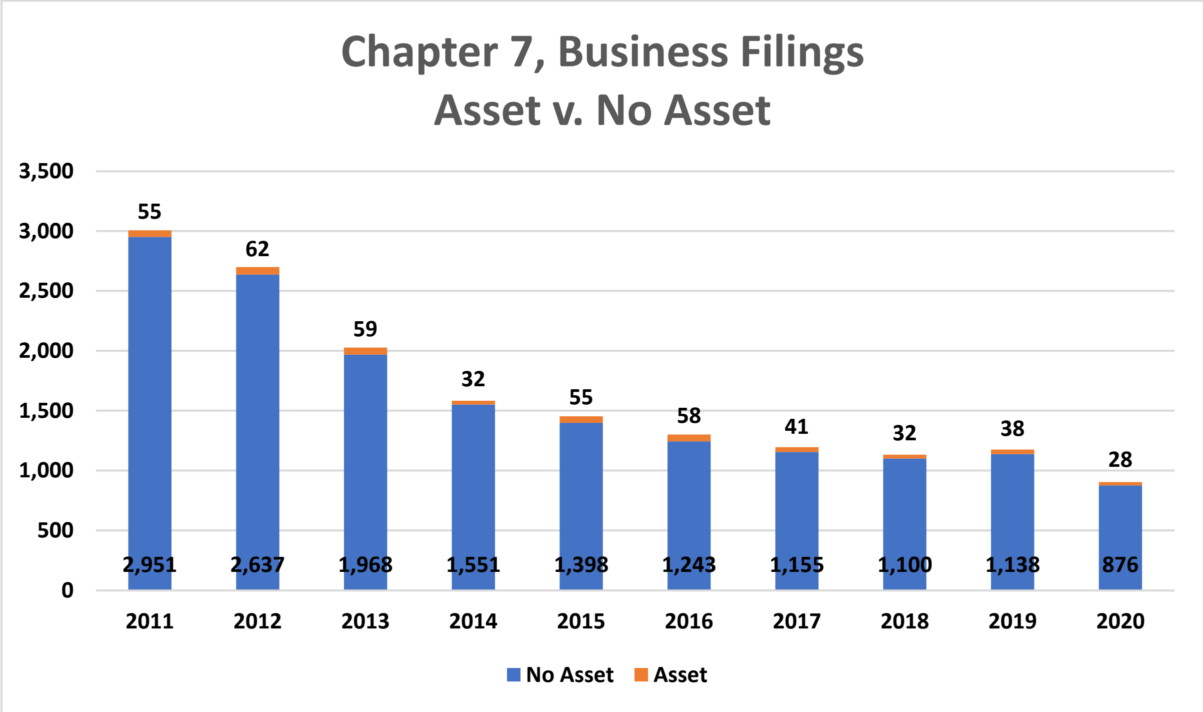
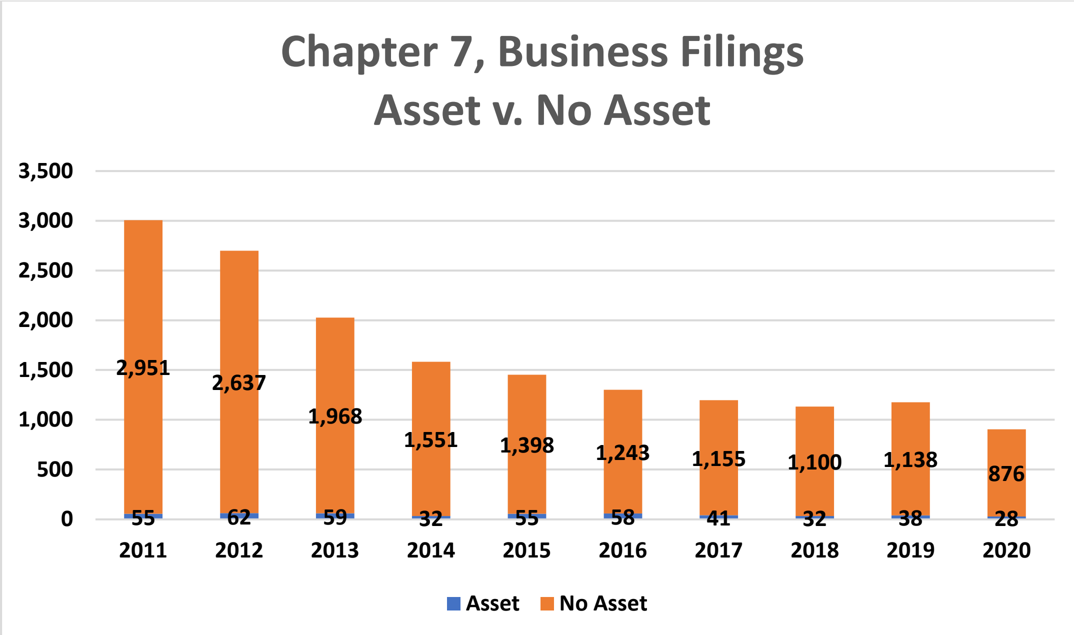
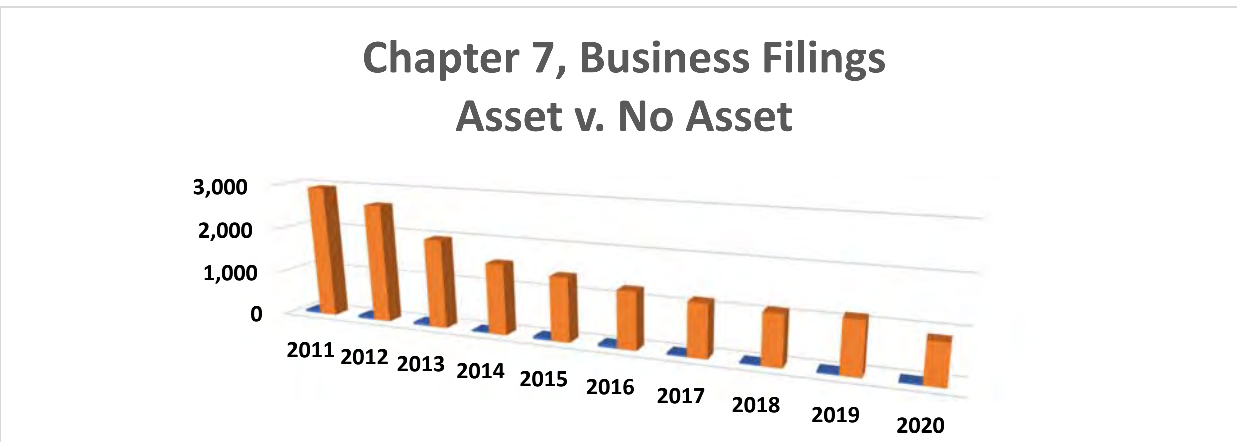
Recent Case Statistics on Chapter 7 Business Filings









	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Asset	55	62	59	32	55	58	41	32	38	28
No Asset	2951	2637	1968	1551	1398	1243	1155	1100	1138	876

Asset No Asset

Source: https://ecf.cacb.uscourts.gov/ecfstatsdash-new.html

Pros and Cons of Filing a Chapter 7 for a Business Entity and Alternatives
February 3, 2021 at 5:00 p.m.

I. Basics of a Corporate Chapter 7 Bankruptcy Filing

- Who can file?
    - Section 101(13) defines "debtor" as a person or municipality concerning which a case under this title has been commenced.
    - Section 101(41) provides that a person includes an individual, partnership, and corporation, and certain limited types of governmental units.
    - Section 101(9) provides that a corporation (A) includes (i) associations having a power or privilege that a private corporation, but not an individual or a partnership, possesses; (ii) partnership associations organized under a law that makes only the capital subscribed responsible for the debts of such association; (iii) joint-stock companies; (iv) unincorporated company or association; or (v) business trusts; but (B) does not include limited partnerships.
- Who cannot file?
    - Section 109 excludes from relief:
        - Railroads (common carrier by railroad engaged in the transportation of individuals or property or owner of trackage facilities leased by such a common carrier);
        - Insurance companies (domestic or foreign insurance companies);
        - Banks (banks, savings banks, cooperative banks, savings and loan associations, building and loan associations, homestead associations, small business investment companies licensed by the Small Business Administration under § 301 of the Small Business Investment Act of 1958, and credit unions or domestic industrial banks insured under the Federal Deposit Insurance Act);
    - Issues arise about whether companies that engage in insurance-like or banking-like activities or are subject to relevant agency regulations were meant to be excluded from bankruptcy relief.
        - SUBSTANTIAL EQUIVALENT TEST - *See In re Cash Currency Exch.*, 762 F.3d 542 (7th Cir. 1985) (superseded by state statute):
            - "If state law classifies the entity as one that is specifically excluded from being a debtor under 11 U.S.C.S. §109(b)(2), of the Bankruptcy Code, the inquiry generally ends there. If state law does not so classify the entity, the question becomes whether the entity is the substantial equivalent of those in the excluded class . . . . In applying the state classification test to determine eligibility under the Bankruptcy Code, 11 U.S.C.S. §109(b)(2), the court must examine the relevant statute of the state to determine whether the entity, like those in the excluded class, is subject to extensive state regulation; is subject to express

statutory procedures for liquidation or rehabilitation; and conducts business of a public or quasi-public nature."

        - INDEPENDENT CLASSIFICATION TEST - *See In re First Independent Trust Co.*, 101 B.R. 206 (Bankr. E.D. 1989):
            - "Under the independent classification test, the court construes section 109(b)(2) itself. Thus, I consider whether First Independent Trust Company is a bank in the generic sense. A common denominator of the financial institutions that are listed at section 109(b)(2) includes the ability to accept deposits . . . . The authority to receive savings deposits, but not demand deposits, was sufficient to make an institution a banking corporation that was ineligible for relief under the former Bankruptcy Act."

- Formalities of a corporate Chapter 7 filing
    - Corporations may file for bankruptcy only with board of director approval
    - Corporations must also disclose information about their owners
        - See Bankruptcy Rule 1007(a)(1) – the debtor shall file with the petition a corporate ownership statement containing information described in Bankruptcy Rule 7007.1.
            - Required disclosures: a statement that identifies any corporation, other than a governmental unit, that directly or indirectly owns 10% or more of any class of the corporation's equity interests, or states that there are no entities to report under this subdivision.
            - Timing: the required disclosures shall be made with the first appearance, pleading, motion, response, or other request addressed to the court.
    - Limited Liability Companies may file but must be aware of the terms of the operating agreement
        - Note: It is generally against public policy for a debtor to waive bankruptcy protection. *See Continental Ins. Co. v. Thorpe Insulation Co. (In re Thorpe Insulation Co.)*, 671 F.3d 1011, 1026 (9th Cir. 2012).
        - However, LLCs can often be a node in a complicated web of holding companies and subsidiaries. Before filing, an attorney should check the LLC operating agreement/s, especially for any negative consequences to the other entities.
- Lack of Proper Authority to File the Entity's Bankruptcy.
    - General partnerships
        - Failure to obtain the consent of all general partners for the filing can result in lack of jurisdiction of the bankruptcy court, dismissal. *In re Cloverleaf Properties*, 78 B.R. 242 (B.A.P. 9th Cir. 1987) – Although under state law, a general partner may ordinarily bind a partnership without the consent of the other general partners, in bankruptcy this rule is reversed. A voluntary petition in bankruptcy requires the consent of all general partners under *Fed. R. Bankr. P.*

1004(a). A petition filed by less than all the general partners of a partnership is treated as commencing an adversary proceeding, subject to certain procedural safeguards. This system prevents fewer than all general partners of a partnership from placing the partnership in a bankruptcy without providing the non-consenting general partners with notice and an opportunity to be heard. The notice required is a summons, served either personally or by mail, informing the non-filing partner that a petition has been filed and that if he opposes, an answer must be filed within twenty (20) days after service of the summons. *Citing In re R.S. Pinellas Motel Partnership*, 5 B.R. 269 (Bankr. M.D. Fla. 1980), the court noted that a partner "answering" or objecting to the bankruptcy filing can be equitably estopped from opposing if he did not do so at the outset, if he colluded with the filing partner, if he was aware of the proceedings early on, or where he was actively involved in the proceedings.

    - Court does not abuse its discretion imposing Rule 9011 sanctions for failure to obtain consent of all general partners for a partnership bankruptcy. *O'Malley v. Okun (In re 5340 Los Robles)*, 2005 Bankr. LEXIS 3401 (B.A.P. 9th Cir. Nov. 4, 2005).
  - Corporations
    - Bankruptcy petition lacking requisite authority by the board of directors must be dismissed. *See Sino Clean Energy, Inc. v. Seiden*, 901 F.3d 1139 (9th Cir. 2018).
    - However, unresolved disputes over stock ownership may not prevent majority owner from having authority to file a bankruptcy petition). *In re Cadiz*, 278 B.R. 744 (Bankr. N.D. Tex. 2002); *see also In re Player Wire Wheels, Ltd*. 421 B.R. 864 (Bankr. N.D. Ohio 2009); *In re Strata Title, LLC*, 2014 WL 661174 (B.A.P. 9th Cir. 2014).
- What happens when a Chapter 7 Bankruptcy is filed by an Entity?
  - Automatic Stay (11 U.S.C. Section 362) stops all litigation <u>against</u> Debtor and its property (i.e., foreclosure, levies, etc.).
  - The automatic stay does not halt litigation by Debtor (although most state court judges will be hesitant to continue without a bankruptcy court order). However, the Chapter 7 Trustee is now the real party in interest (i.e., great opportunity for a Defendant to try and settle). Plaintiff's counsel (or retained bankruptcy counsel) should attend the 11 U.S.C. Section 341a meeting of creditors and reach out to the Chapter 7 Trustee to attempt to settle. Any settlement with the Chapter 7 Trustee must be approved by the Bankruptcy Court and can be objected to by the Debtor/Defendant.
  - Plaintiff must notify State Court in pending actions in California if Defendant files bankruptcy (Cal. Rules of Ct. Rule 3.650).
- Entities Do Not Receive a Discharge of Their Debts
  - Bankruptcy Code 11 U.S.C. Section 727(a)(1) states that the court shall grant the Debtor a discharge unless the Debtor is not an individual.

    - Entities can only receive a discharge through the Chapter 11 process.

II. What are the Benefits of a Corporate Chapter 7 Bankruptcy Case Even if There is No Discharge?

- The automatic stay temporarily ceases all litigation.
    - The filing may re-adjust litigating creditors' expectations for recovery and desire to continue on.
    - Creditors less likely to continue incurring the costs of litigation, versus filing a proof of claim.
- Reduce Tax Losses
    - If a debt is deemed no longer collectible and worthless, it can be written off.
    - A bankruptcy filing can be used as evidence that a debt is uncollectible as the debtor is insolvent.
    - Standard for when a debt is no longer collectible is subject to interpretation – check with your CPA.
- The risk of alter ego litigation drops significantly.
    - The longer the debt remains unpaid, the more likely a creditor may attempt to tack on an alter ego claim to their ordinary collection claim.
    - However, alter ego claims are risky, hard to prove, and less likely to be asserted absent a sound factual basis.
    - *Associated Vendors, Inc. v. Oakland Meat Co.*, 210 Cal. App. 2d 825 (1962):
        - Before a corporation's acts and obligations can be legally recognized as those of a particular person, and vice versa, it must be made to appear that the corporation is not only influenced and governed by that person, but that (1) there is such a unity of interest and ownership that the individuality, or separateness, of such person and corporation has ceased, and (2) that the facts are such that an adherence to the fiction of the separate existence of the corporation would, under the particular circumstances, sanction a fraud or promote injustice. Both of these requirements must be found to exist before the corporate existence will be disregarded.
        - Factors (extensive case law examining and clarifying each):
            - Commingling of funds and other assets, failure to segregate funds of the separate entities, and the unauthorized diversion of corporate funds or assets to other than corporate uses;
            - the treatment by an individual of the assets of the corporation as his own;
            - the failure to obtain authority to issue stock or to subscribe to or issue the same;
            - the holding out by an individual that he is personally liable for the debts of the corporation;

        - the failure to maintain minutes or adequate corporate records, and the confusion of the records of the separate entities;
        - the identical equitable ownership in the two entities;
        - the identification of the equitable owners thereof with the domination and control of the two entities;
        - identification of the directors and officers of the two entities in the responsible supervision and management;
        - sole ownership of all of the stock in a corporation by one individual or the members of a family;
        - the use of the same office or business location;
        - the employment of the same employees and/or attorney;
        - the failure to adequately capitalize a corporation;
        - the total absence of corporate assets and undercapitalization;
        - the use of a corporation as a mere shell, instrumentality or conduit for a single venture or the business of an individual or another corporation;
        - the concealment and misrepresentation of the identity of the responsible ownership, management and financial interest, or concealment of personal business activities;
        - the disregard of legal formalities and the failure to maintain arm's length relationships among related entities;
        - the use of the corporate entity to procure labor, services or merchandise for another person or entity;
        - the diversion of assets from a corporation by or to a stockholder or other person or entity, to the detriment of creditors, or the manipulation of assets and liabilities between entities so as to concentrate the assets in one and the liabilities in another;
        - the contracting with another with intent to avoid performance by use of a corporate entity as a shield against personal liability, or the use of a corporation as a subterfuge of illegal transactions; and
        - the formation and use of a corporation to transfer to it the existing liability of another person or entity.
    - A bankruptcy filing minimizes the likelihood of a collection lawsuit, such that an alter ego claim will have to be made on its own and supported by separate factual allegations.
    - Creditors in alter ego claims are liable to alleged alter egos for attorney's fees if they are unsuccessful in their case. *347 Group, Inc. v. Philip Hawkins Architect, Inc.*, 58 Cal. App. 5th 209 (2020) ("Action on a contract" for which fees are available under Cal. Civ. Code § 1717(a) is construed liberally and may include tort claims involving a contract in which the prevailing party is entitled to attorney fees under that contract.).

    - Note: Cal. Civ. Proc. Code § 187 allows trial courts to add additional debtors to an existing judgment, including alter egos and successor entities. As noted in *Wolf Metals, Inc. v. RPS*, 4 Cal. App. 5th 698 (2017), because an entity does not receive a discharge in Chapter 7, a creditor can continue to pursue alter ego claims based on fraudulent conveyances to successor corporations after the close of the bankruptcy case.
- Audit risk is reduced.
    - If the tax debtor is insolvent, there is no means to pay additional taxes/assessments following the audit.
    - Taxing agencies overwhelmed with solvent debtors.
    - From a practical standpoint, audits are less likely if not likely to produce additional tax revenue. Exception arising for personal liability resulting from an audit (i.e., payroll tax liability).
    - Make sure to file all returns.
- Debt collection process in the United States includes verification that the Debtor is insolvent.
    - All bankruptcy filings require Schedules and Statement of Financial Affairs to be filed under penalty of perjury. This information includes the balance sheet, profit/loss data, and disclosures of asset transfers, pending litigation, financial accounts, safe deposit boxes, property held for another, location of books and records, payments to insiders, etc.
    - If any entity establishes that the company has ceased operating and is being liquidated, any future collection efforts would be a waste of time. If the Chapter 7 Trustee cannot find any more assets to liquidate, then how can the debt be collected?
- Although no discharge is received, a bankruptcy filing can have the same effect by ceasing collection efforts.
    - Most debt collection is done by non-lawyers (A/R departments or debt collectors) who don't understand the reality that entities do not receive a discharge in a Chapter 7.
    - Notice of a Chapter 7 Bankruptcy Filing can be the equivalent of a death certificate or strong signal that the company is out of business and is liquidating.
    - A Chapter 7 Trustee is in the best position to liquidate the assets of the company.
    - Non-attorney debt collectors (who often receive a share of the amount collected) will be dissuaded because the value of any future effort will appear to be zero. Collections are stayed by the automatic stay and a clear message has been sent that there is nothing to collect.
    - Bottom line is that a Chapter 7 Bankruptcy filing by an entity will cease all collection efforts, unless there is insurance.
- A bankruptcy filing can ease the stress of a failing business and dealing with creditors.
    - Running a failing business with limited resources is very stressful on ownership and management. Proving financial problems by phone, email

and/or financial statements is very time consuming and is faced with a lot of skepticism from collectors.
    - Turning over the liquidation process can cost less than alternatives and can eliminate/reduce this stress and provide information to all creditors at one time.
    - Debtor's management need only satisfy the bankruptcy trustee's requests and comply with Debtor duties, e.g., Section 521, Bankruptcy Rule 4002. Those duties can consume less time and involve less stress than pursuing alternative liquidation strategies.
- Selling Assets Free and Clear of Claims
    - An owner or insider can purchase the assets of an entity from the Chapter 7 Trustee on behalf of the bankruptcy estate.
    - The sale will be by auction or subject to overbid and can be free and clear of claims. 11 U.S.C. § 363(f).
    - A bankruptcy court order will be entered approving such sale, which is great protection for the buyer.
    - After the sale has concluded, any issues with such sale by other creditors or third parties will be before the bankruptcy court. The validity of such sales may not be challenged if the bankruptcy court makes a good faith purchaser finding. 11 U.S.C. § 363(m). *See also In re Ewell*, 958 F.2d 276, 281 (9th Cir. 1992) (A good faith purchaser is one who buys "in good faith and "for value.")
    - A bankruptcy court order approving a sale free and clear of interests avoids the risks of a bulk sale and the costs involved in possible fraudulent conveyance and/or successor liability lawsuits by disgruntled creditors.

III. What are the Pitfalls of a Corporate Chapter 7 Bankruptcy Case?

- Existence of Transfers Prior to the Bankruptcy Filing that May be Pursued by the Chapter 7 Trustee (i.e., Fraudulent Conveyances and Preferential Transfers). An entire seminar can be devoted to these two areas of bankruptcy law, so the intricacies will not be discussed herein.
- Preferential Transfers
    - Payment on an old debt within ninety (90) days of a bankruptcy filing. If a debtor has certain friendly creditors that it does not want to have to face a claw back by a Chapter 7 Trustee, then delay the filing.
    - Note: As of February 19, 2020, Section 547(b) now requires a debtor or trustee before commencing a preference action to consider a party's statutory defenses based on reasonable due diligence in the circumstances of the case and taking into account a party's known or reasonably knowable affirmative defenses.
    - Insider loans and payments (other than compensation and expense reimbursements) can be clawed back up to one (1) year prior to the bankruptcy filing. The repayment of insider loans is typically not an issue unless a bankruptcy is filed.

- A thorough review of an entity's books and records must be done to avoid any surprises as to these types of transfers that might negate any possible benefit of a bankruptcy filing.

- Claims Arising from the Breach of Fiduciary Duty, Related Theories
  - FIDUCIARY DUTIES - Cal. Corp. Code § 309(a) - A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.
  - See Cal. Corp. Code § 17704.09 for fiduciary duties of loyalty, care owed by managers, members of a limited liability company.
  - *Lehman v. Superior Court*, 145 Cal. App. 4th 109, 121 (2006) - The liability of a corporate fiduciary for wrongful acts and omissions did not come into being solely by virtue of that statute. Corporations Code section 309 was enacted in 1975. A director's fiduciary duty at common law—generally, to act with honesty, loyalty, and good faith—predated the statute by decades.
  - BUSINESS JUDGMENT RULE – *Solution Trust v. 2100 Grand LLC (In re AWTR Liquidation Inc.)*, 548 B.R. 300, 314 (Bankr. C.D. Cal. 2016) (summarizing relevant California and Delaware cases):
    - The effect of the business judgment rule is to raise the burden of proof from ordinary negligence to gross negligence -- i.e., failure to exercise even slight care. Put differently, corporate directors will not be held liable for a negligent judgment (i.e., one a reasonably prudent person would not have made) so long as the process leading to the judgment meets business judgment rule requirements. In other words, courts will not second guess the decisions of disinterested directors made with reasonable diligence in ascertaining the facts and believed to be in the corporation's best interests. This is so even if the directors make a bad or "stupid" decision. But the process is critical. The business judgment rule presupposes that judgment -- reasonable diligence -- has in fact been exercised, and a director cannot close his eyes to what is going on about him in the conduct of the business of the corporation and have it said that he is exercising business judgment.
  - TRUST FUND DOCTRINE - *Berg & Berg Enterprises, LLC v. Boyle*, 178 Cal. App. 4th 1020, 1040 (2009) – California cases recognize the trust fund doctrine where all of assets of a corporation, immediately on its becoming insolvent, become a trust fund for the benefit of all of its creditors in order to satisfy their claims . . . . [T]he scope of the trust fund doctrine in California is reasonably limited to cases where directors or officers have diverted, dissipated, or unduly risked the insolvent corporation's assets. In other words, the doctrine is not applied to create a

duty owed by directors to creditors solely due to a state of corporate insolvency. Application of the doctrine requires, in addition, that directors have engaged in conduct that diverted, dissipated, or unduly risked corporate assets that might otherwise have been used to satisfy creditors' claims. We accordingly hold that the scope of any extracontractual duty owed by corporate directors to the insolvent corporation's creditors is limited in California, consistent with the trust fund doctrine, to the avoidance of actions that divert, dissipate, or unduly risk corporate assets that might otherwise be used to pay creditors claims. This would include acts that involve self-dealing or the preferential treatment of creditors. Further, because all the California cases applying the trust fund doctrine appear to have dealt with actually insolvent entities, and because the existence of a zone or vicinity of insolvency is even less objectively determinable than actual insolvency, we hold that there is no fiduciary duty prescribed under California law that is owed to creditors by directors of a corporation solely by virtue of its operating in the "zone" or "vicinity" of insolvency.

    - Note: Self-dealing in violation of the trust fund doctrine may also be nondischargeable defalcation by corporate insiders under Section 523(a)(4). *See Oney v. Weinberg (In re Weinberg)*, 410 B.R. 19 (B.A.P. 9th Cir. 2009) (applying Arizona Trust Fund Doctrine); *see also Yin-Ching Houng v. Tatung Co. (In re Yin-Ching Houng)*, 636 Fed. Appx. 396 (9th Cir. 2016) (upholding similar finding under California Trust Fund Doctrine).

  - DEEPENING INSOLVENCY THEORY - *Smith v. Arthur Andersen LLP*, 421 F.3d 989, 1003-04 (2005) (internal citations omitted): "We need not make any general pronouncements on the deepening insolvency theory, not least because it is difficult to grasp exactly what the theory entails. We do, however, agree with the Third Circuit's observation in *Lafferty* that 'prolonging an insolvent corporation's life through bad debt may' dissipate corporate assets and thereby harm the value of corporate property. Thus, we agree that the complaint states a cognizable harm to Boston Chicken when it alleges that the defendants 'prolonged' the firm's existence, causing it to expend corporate assets that would not have been spent 'if the corporation [had been] dissolved in a timely manner, rather than kept afloat with spurious debt.' In so holding, we do not opine whether the incurrence of additional debt that cannot be repaid, in and of itself, constitutes a corporate injury remediable by a trustee. We rely only on the dissipation of assets in reaching the conclusion that Boston Chicken was harmed."

- Fraudulent Conveyances
  - Actual fraud or transfers for less than reasonably equivalent value.
  - Claw-back period is two (2) years under the Bankruptcy Code, or the Chapter 7 Trustee can assert a claim pursuant to California Code of Civil Procedure Section 3439.09 for up to seven (7) years.

- Claw-back period may be ten (10) years in cases where the Internal Revenue Service is a creditor. *See Hillen v. City of Many Trees, LLC (In re CVAH, Inc.)*, 570 B.R. 816 (Bankr. D. Id. 2017) (trustee can step into the shoes of the IRS and utilize the transfer avoidance provisions of the Federal Debt Collection Procedures Act or the Internal Revenue Code).
- A thorough analysis must be conducted of all transfers of the entity's assets that are outside the ordinary course of business.
- Note: corporate insiders may be individually liable for fraud nondischargeability pursuant to Section 523(a)(2)(A). *Husky Int'l Elecs., Inc. v. Ritz*, 136 S. Ct. 1581, 1586, 194 L. Ed. 2d 655 (2016) ("The term 'actual fraud' in § 523(a)(2)(A) encompasses forms of fraud, like fraudulent conveyance schemes, that can be effected without a false representation.")

- Substantive consolidation
  - Means of collapsing successor/alter ego entities into the bankruptcy in order to reach and distribute their assets to creditors.
  - Has been recognized by courts as an equitable remedy to combat the commission of fraud upon creditors which might go uncorrected in its absence.
  - Is also used for practical reasons involving intermingling of assets, disregard of corporate formalities, and where inadequate or incomplete financial or corporate records had been kept.
  - Key test in the Ninth Circuit: (1) that creditors dealt with the entities as a single economic unit; or (2) that the affairs of the debtor and the other entities are so entangled that consolidation will benefit all creditors. *Alexander v. Compton (In re Bonham)*, 229 F. 3d 750, 766 (9th Cir. 2000).
  - Substantive consolidation can be extended to individuals where they are "the ring masters behind the labyrinthine system of transactions and transfers of properties that can only be untangled if the individuals use of accounts and property transfers are included." *OMS, LLC v. Bank of Am., N.A.*, 2015 U.S. Dist. LEXIS 152622 *6 (C.D. Cal. Nov. 6, 2015).
  - Because substantive consolidation seriously affects the substantive rights of the creditors of the different estates, notice must be given to all the creditors of the targeted entities or at least attempted to be ascertained. *Leslie v. Mihranian (In re Mihranian)*, 937 F.3d 1214, 1218 (9th Cir. 2019).
- Loss of the Attorney-Client Privilege
  - Chapter 7 Trustee owns the attorney-client privilege once the bankruptcy case is filed and can demand all attorney-client communications from all attorneys of the entity.
  - The entity and its attorneys must consider the full disclosure of their communications before filing.
  - Cases on Chapter 7 Trustee's ability to waive the attorney-client privilege:
    - *Community Futures Trading Com v. Weintraub*, 471 U.S. 343 (1985)
    - *In re Eddy*, 304 B.R. 591 (Bankr. D. Mass. 2004);

        - *In re R.J. Dooley Realty, Inc*., 2010 Bankr. LEXIS 1761 (Bankr. S.D.N.Y. 2010); and
        - *In re Hechinger Inv. Co. of Del., Inc*., 285 B.R. 601 (Bankr. D. Del. 2002).
- Conflicts of Interest/Potential Professional Liability
    - An attorney retained by a debtor entity must be aware that he/she represents the entity and not its shareholders, officers, or directors.
    - In some circumstances, a trustee may conclude that the corporate debtor's counsel, prepetition, aided the self-dealing of insiders in violation of the trust fund doctrine. This may give rise to professional liability:
        - See California Rule of Professional Conduct 1.13 (effective Nov. 1, 2018): If a lawyer representing an organization knows that a constituent is acting, intends to act or refuses to act in a matter related to the representation in a manner that the lawyer knows or reasonably should know is (i) a violation of a legal obligation to the organization or a violation of law reasonably imputable to the organization, and (ii) likely to result in substantial injury to the organization, the lawyer shall proceed as is reasonably necessary in the best lawful interest of the organization. Unless the lawyer reasonably believes that it is not necessary in the best lawful interest of the organization to do so, the lawyer shall refer the matter to higher authority in the organization, including, if warranted by the circumstances, to the highest authority that can act on behalf of the organization as determined by applicable law.
- Serious Ramifications for Not Disclosing Assets or Transfers
    - All bankruptcy court filings and the testimony to be provided at the Section 341a meeting of creditors is under penalty of perjury.
    - Criminal and civil penalties for not disclosing assets or transfers.
    - Depending on the circumstances, Debtors' attorneys can be subject to orders of disgorgement for inadequate services (including inadequate investigation/disclosure) on behalf of the Debtor. See 11 U.S.C. § 329(b).

IV. Time of a Bankruptcy Case Remaining Open

- An entity with no or little assets and no recoverable transfers will close in 3-6 months.
- A case with assets to liquidate or transfers to pursue (in adversary proceedings filed in the bankruptcy case that are fast tracked, bench trial cases) can be open for years with the automatic stay in place.
- General Rule is the more in assets the Chapter 7 Trustee has, the more likely litigation (i.e., transfers, etc.) will be pursued.
- Best to file for the entity with as little assets as possible.

V. Alternatives to a Corporate Chapter 7 Bankruptcy Case?

- ABC – Assignment for Benefit of Creditors pursuant to California Code of Civil Procedure Sections 493.010 - 493.060 1800 et. seq.
    - Benefits over Chapter 7

      - An ABC can create value for all creditors by terminating a lien of a temporary protective order or attachment if the lien was created within 90 days prior to the making of the general assignment. See Cal. Civ. Proc. Code § 493.030.
      - An assignee has the right to occupy any business premises that the assignor held under a lease upon payment of ordinary rent for up to 90 days after the date of the assignment. Cal. Civ. Proc. Code § 1954.05.
      - While there is no automatic stay, the assignor becomes a shell entity as the assets have been deemed transferred to the Assignee as the custodian who holds a statutory lien from the date of assignment to deter litigation and threats of pre-judgment attachments. See Cal. Com. Code § 9102(52)(A)(ii).
      - Unlike in Chapter 7, Debtor has the right to choose the fiduciary to act as assignee.
      - Reduced costs and red tape as there are no committees, government agencies, or courts that are automatically involved in the general assignment. ABCs are intended to be out-of-court processes.
      - Potentially less involvement by the Debtor in an ABC as opposed to Chapter 7, but assets still must be attested to by affidavit.
      - Assignees can act more quickly than bankruptcy trustees to take possession and marshal the assets for sale, utilizing existing staff to collect AR, prepare the assets for sale, etc.
      - Assignees may be more willing to operate the business to preserve going concern value than bankruptcy trustees.
      - Potentially a lot less publicity associated with the endeavor as compared with public Chapter 7 and receivership proceedings.
   - Risks
      - Assignee can still pursue: (i) fraudulent conveyance claims under state law and (ii) preference claims. Assignee's preference powers are broader than the bankruptcy trustee's. *Compare* Cal. Civ. Proc. Code §§ 1800-1802 *with* 11 U.S.C. § 547.
      - Assignee does not have the ability to assign leases and executory contracts without the consent of the counterparty.
      - Although intended to be an out-of-court process, ABCs can also be the subject of litigation. *See El Saad v. Tarakji*, 2011 WL 5910059 (Cal. App. 4 Dist.) (unpublished) (upholding finding that an ABC was a fraudulent conveyance scheme in disguise).
   - For more information, please review sample ABC overview material provided by ABC Services Group, Inc.

- Dissolution – State law provides for self-liquidation. No Court supervision. Subject to possible abuse, which might result in an involuntary bankruptcy filing. See attached Dissolution Statutes.
   - <u>Delaware</u>

        - Corporations – Title 8, Chapter 1, Subchapter X. Sale of Assets, Dissolution and Winding Up (§271 - §285);
        - LLCs – Title 6, Chapter 18, Subchapter VIII. Dissolution (§18-801 - §18-806)
    - <u>California</u>
        - Corporations – Title 1 Corporations, Division 1, Chapter 18 Involuntary Dissolution or Voluntary Dissolution by Petition of Corporation to Superior Court (§ 1800 – § 1809)
            - See Cal. Corp. Code § 1904 - If a corporation is in the process of voluntary winding up, the superior court of the proper county, upon the petition of (a) the corporation, or (b) a shareholder or shareholders who hold shares representing 5 percent or more of the total number of any class of outstanding shares . . . and upon such notice to the corporation and to other persons interested in the corporation as shareholders and creditors as the court may order, may take jurisdiction over such voluntary winding up proceeding if that appears necessary for the protection of any parties in interest. The court, if it assumes jurisdiction, may make such orders as to any and all matters concerning the winding up of the affairs of the corporation and for the protection of its shareholders and creditors as justice and equity may require. The provisions of Chapter 18 (commencing with Section 1800) (except Sections 1800 and 1801) shall apply to such court proceedings.
        - Corporations – Title 1 Corporations, Division 1, Chapter 19 Voluntary Dissolution (§ 1900 – § 1907)
            - Election to wind up and dissolve by (a) vote of shareholders representing 50%+ of voting power or (b) if (1) the corporation is in Chapter 7 bankruptcy, (2) the corporation has disposed of all its assets and has not conducted any business for a period of 5 years preceding the resolution to electing to dissolve, or (3) the corporation issued no shares.
            - General steps for wind-down process are: (1) internal corporate approvals, (2) notice to creditors, (3) compliance with government requirements, (4) collecting debts and setting claims, (5) liquidating and distributing assets, and (5) administrative tasks, such as filing appropriate certificates.

        - LLCs – Title 2.6 California Revised Uniform Limited Liability Act, Article 7 Dissolution and Winding Up (§17707.01 – §17707.09)

        - Refer to attached sample "Dissolution Requirements – What Form to File" checklist for California Stock Corp. from CA SOS website. https://bpd.cdn.sos.ca.gov/corp/pdf/dissolutions/corp_stkdiss.pdf

- Receiverships – Cal. Civ. Proc. Code § 564; Fed. R. Civ. P. 66, 69(a)
    - Most often seen as a pre- or post-judgment collection remedy (see Cal. Civ. Proc. Code § 708.620), but also can be appointed on petition of a creditor or shareholder of a corporation that is the subject of a dissolution in superior court. See Cal. Civ. Proc. Code § 565:
        - Upon the dissolution of any corporation, the Superior Court of the county in which the corporation carries on its business or has its principal place of business, on application of any creditor of the corporation, or of any stockholder or member thereof, may appoint one or more persons to be receivers or trustees of the corporation, to take charge of the estate and effects thereof, and to collect the debts and property due and belonging to the corporation, and to pay the outstanding debts thereof, and to divide the moneys and other property that shall remain over among the stockholders or members.
    - This can be an appropriate procedure in the case of warring partners of a business entity and an impasse over how to liquidate.
        - As noted *supra*, the filing of a Chapter 7 case for an entity without corporate authorization can in some cases lead to Rule 9011 sanctions and dismissal. ABCs also require corporate approvals. Depending on the assets at stake in the company, receivership may be the appropriate remedy.
        - *See also* Cal. Corp. Code § 308 permitting the appointment of a provisional director in the case of deadlocked corporations.
    - Federal receiverships are authorized under FRCP 66 but in the absence of dedicated statute governing the federal receiver, Rule 69(a) is the basis for following state law and procedures.
    - *Morand v. Superior Court*, 38 Cal. App. 3d 347, 351 (1974) - California adheres to the principle that the power to appoint a receiver is a delicate one which is to be exercised sparingly and with caution. It is said that the state's courts that the appointment of a receiver is an extraordinary and harsh, and delicate, and drastic remedy to be used cautiously and only where less onerous remedies would be inadequate or unavailable. A party to an action should not be subjected the onerous expense of a receiver, unless his appointment is obviously necessary to the protection of the opposite party.
    - The appointment of any particular receiver can be challenged by the proposal of a party in interest of a different receiver and the reasons why. California Rules of Court, Rule 3.1177.
    - Cal. Civ. Proc Code § 568. The receiver has, under the control of the Court, power to bring and defend actions in his own name, as receiver; to

take and keep possession of the property, to receive rents, collect debts, to compound for and compromise the same, to make transfers, and generally to do such acts respecting the property as the Court may authorize.

  - Intangible assets such as patents, domain names may only be reachable under state law by way of receiver. *See Yufa v. TSI Inc.*, 2018 U.S. Dist. LEXIS 140115 (N.D. Cal. Aug. 17, 2018); *Palacio Del Mar Homeowners Assn., Inc. v. McMahon*, 174 Cal. App. 4th 1386 (2009).
  - A receiver is treated as a lien creditor under the California Commercial Code from the date of appointment with a lien position superior to any unperfected security interest. See Cal. Comm. Code §§ 9102(52)(E) & 9317(a)(2).
  - Property in possession of the receiver cannot be levied because such property is technically in the custody of the court (*in custodia legis*). *Robbins v. Bueno*, 262 Cal. App. 2d 79 (1968).

- Just Close the Doors? – If no assets to liquidate and no desire to navigate a Chapter 7. Problematic in view of the Trust Fund Doctrine and the Deepening Insolvency Theory and may give rise to an involuntary bankruptcy risk. It is beneficial to the entity, the principals, and the creditors to attempt to wind up the affairs of the entity.

- File Individually and List Corporate Debt for Info Purposes Only – If the filing debtor is an individual and 100% owner of the business, both of which are insolvent, an attorney might consider only filing the individual's bankruptcy and list entity debt in the individual filing as "for information purposes only." This puts entity creditors on notice that they must assert alter ego claims in an individual's bankruptcy case.
  - Expansive notice is a top priority in this scenario, especially if the Trustee identifies and liquidates assets. *See In re Beezley*, 994 F.3d 1433, 1435-36 (9th Cir. 1993):
    - Section 523(a)(3) threatens nondischargeability in order to safeguard the rights of creditors in the bankruptcy process. The difference between subparagraphs (A) and (B) reflects the different rights enjoyed by and requirements imposed upon different kinds of creditors. For most creditors, the fundamental right enjoyed in bankruptcy is to file a claim, since this is the sine qua non of participating in any distribution of the estate's assets. Section 523(a)(3)(A) safeguards this right by excepting from discharge debts owed to creditors who did not know about the case in time to file a claim. By contrast, for creditors holding intentional tort claims the salient rights are not only to file a claim but also to secure an adjudication of nondischargeability. Thus, section 523(a)(3)(B) excepts intentional tort debts from discharge notwithstanding the creditor's failure to file a timely complaint under section 523(c) if the creditor did not know about the case in

time to file such a complaint (even if it was able to file a timely proof of claim).

- o Note: in the case of a debtor who is the single member of a single-member LLC, the Chapter 7 Trustee takes over all rights and interests in the LLC (including the right to file for bankruptcy*).* *See In re Albright*, 291 B.R. 538, 541 (Bankr. D. Colo. 2003).

VI. CONCLUSIONS

- Many factors need to be considered before filing a Chapter 7 case for an entity.
- Otherwise dormant litigation can be reignited by a Chapter 7 Trustee, especially against insiders and/or if there are potential recoveries for the bankruptcy estate.
- Even if the insolvent entity has no assets, the insiders may have assets recoverable under various theories of prepetition mismanagement and ongoing inequitable conduct.
- An attorney filing a corporate Chapter 7 should ensure broad notice to all creditors (current and old creditors, partners, associates, etc.) so that they all can verify that there is no benefit to investing effort and money to pursue an uncollectible debt.
- Management can be relieved of the burdens of operating a sinking ship and dealing with frustrated/aggressive creditors.
- In the correct circumstances, a Chapter 7 filing for an entity can provide an economically efficient process for creditors to confirm the amount, if anything, that they will be paid and that all recoverable assets have been disclosed.

PROVISIONS OF CALIFORNIA LAW PERTAINING TO GENERAL ASSIGNMENTS FOR BENEFIT OF CREDITORS

Civil Code:

§ 1954.1	**Landlord Provisions**
§ 3439.07	**Remedies of Creditor in Action for Relief Against (Fraudulent) Transfer**
§ 3440	**Transfer of Personal Property Without Immediate Transfer of Possession Fraudulent**
§ 3440.1(a)	**Exceptions**

Code of Civil Procedure:

§ 493.030(a) et. seq.	**Pre-Assignment Attachments**
§ 1204, 1204.5	**Priorities (wages; customer depositors)**
§ 1800	**Preferences**
§ 1800(c) (3)	**Unperfected Security Interests**
§ 1800	**Fraudulent Transfer**
§ 1801	**Exemptions**
§ 1802	**Written Notice of Assignments**

Uniform Commercial Code:

§ 6103 (2)	**Transfers Exempt from (Bulk Transfer) Article**
§ 9102 (52) (ii)	**Assignee as "lien creditor"**
§ 9309 (12)	**Assignee - Perfection of Security Interest**

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GENERAL **A**SSIGNMENT FOR THE **B**ENEFIT OF **C**REDITORS

ABC's - AN ALTERNATIVE TO CHAPTER 7 BANKRUPTCY

Some businesses cannot continue to operate and must therefore be closed and their assets liquidated. A General Assignment for the benefit of creditors is an alternative to Chapter 7 bankruptcy. A General Assignments is administered under common law and saves time and expense in concluding the affairs of an insolvent company. It is beneficial to the principals who have personally guaranteed company obligations and/or are personally liable for taxes. It can also benefit the secured creditor who often prefers not to foreclose on its collateral, by relieving them of the legal cost and risks of foreclosure and sale of collateral. The lower cost of liquidation in a General Assignment preserves more of the assets for the unsecured creditors, and frequently the Assignee is able to be more creative in selling the assets to maximize values, as compared to a bankruptcy Trustee.

WHAT IS A GENERAL ASSIGNMENT

A General Assignment is a contract. The troubled entity (the Assignor) transfers title and possession of all its assets to a third party (the Assignee), in trust for creditors. Unsecured creditors of the Assignor cannot levy upon the assets of "the assigned estate" but must await the Assignee's liquidation of the assets and pro-rata distribution of the proceeds to the creditors according to law.

HISTORY OF GENERAL ASSIGNMENTS

General Assignments are recognized under the laws of most States, and the Assignee is defined as a "custodian" under the US Bankruptcy Code. In California and other states the practice is well established, and State laws parallel the Bankruptcy Code in many respects, especially in protecting the assets and providing for fair and equitable distributions to creditors.

WHO CAN MAKE AN ASSIGNMENT?

The general rule is that any person or business entity may execute a General Assignment. However, individuals usually prefer to file a Chapter 7 bankruptcy petition to obtain a discharge from (most) debts. A partner may assign partnership assets. Where the Assignor is a multiple or collective entity (a corporation or partnership), a majority of the ownership interest(s) should consent in writing to the Assignment. The board of directors of a corporation must adopt a resolution authorizing the General Assignment.

ASSIGNABLE PROPERTY

To be recognized as a General Assignment, the Assignor must assign to the Assignee all assets including cash, real and personal property, and “general intangibles.” The last category includes trade names, customer list, book accounts, patents, copyrights, and rights, claims and credits of all kinds. Both the transfer of the assets to the Assignee and the Assignee’s subsequent sale of the physical assets to a buyer are exempt from bulk sales laws. The Assignee becomes a lien creditor with the right (and duty) to attack any unperfected security interest. Under California law an Assignee can also sue in State court to overturn “preferences” and “fraudulent transfers,” generally to the same extent as is possible in bankruptcy, and can remove attachments by creditors and forestall eviction by a landlord for up to 60 days to complete liquidation of the physical assets.

A VEHICLE FOR A "QUICK SALE” TO PRESERVE VALUE

Goodwill may be a significant asset whose value can be realized only through a "turn key" sale of an intact business to a buyer willing and able to pay more than the liquidation value of the assets. Following “due diligence” an Assignee can sell the assets to the buyer, usually free and clear of liens. Pending the sale, the Assignee may also operate a business for a short period of time to maintain the going concern value. The entire process should benefit all parties in the case.

ORDERLY LIQUIDATION OF ASSETS; PAYMENT OF CLAIMS

In the event a buyer cannot be found to acquire the business as a going concern, the Assignee will conduct an orderly sale of the physical assets at public auction. Real property will be listed through a broker for a time, and then auctioned. The Assignee also collects the accounts receivable and otherwise liquidates other types of assets the debtor may have. The proceeds are used to pay administrative costs (much less than in bankruptcy), and secured and priority claims according to law. The net proceeds are then distributed *pro-rata* to the unsecured creditors. The process cannot take less than four months but is normally concluded within six months to one year. If longer delays are experienced the Assignee may make interim distributions to creditors, which is never done in Chapter 7 cases.

CONSENT OF CREDITORS TO THE ASSIGNMENT

There is no need to secure the consents of unsecured creditors to a General Assignment. Instead, the Assignee invites all creditors to file their claims in order to receive their pro-rata “dividends.” The Assignee does need the cooperation of the major secured creditor(s) since those creditors have liens against the assets.

RECOVERING PREFERENCES

An Assignee may recover payments or other transfers of property to creditors within 90 days before the Assignment, or within one year if the creditor is an insider and knew the Assignor was insolvent at the time of the transfer.

FREQUENTLY ASKED QUESTIONS [FAQ’s]

Q. What are the costs of a General Assignment?

A. <u>Fees</u> are a small percentage (less than 10%) of the liquidated proceeds and are specified in the General Assignment contract. Since the Assignee's fee is a percentage of the dollars it collects from the liquidation assets, the Assignee has an incentive to maximize the recovery for all creditors. In addition, the Assignee is reimbursed from the liquidated proceeds for the out of pocket costs of preserving and selling the assets and collecting the receivables, including the expenses of professionals.

Q. Can a General Assignment be made if law suits or attachments are pending?
A. Yes. An Assignment immediately eliminates the effect of a creditor attachment or temporary protective order, and would make ineffective a judgment obtained by a creditor after the Assignment. A judgment or other lien obtained before the Assignment may be a lien on assigned property, but may be subject to attack by the Assignee as a preference if it was created within 90 days before the General Assignment in order to secure antecedent debt. Otherwise, perfected liens on the Assignor's assets are unaffected by the Assignment and must be paid prior to payment of unsecured claims.

Q. How is existing litigation in favor of the Assignor handled by the Assignee?
A. As a fiduciary, the Assignee will determine the cost benefit analysis of continuing to prosecute any existing litigation that the Assignor may have pending at the time of the Assignment. Key issues that the Assignee must consider are (a) the Assignment Estate's ability to continue to fund the cost of the litigation (b) the probability of the Assignment Estate receiving some economic benefit of recovery well in excess of the funds invested to continue prosecution of the litigation, and (c) the Assignee's ability to negotiate an agreement with existing counsel to continue to prosecute the litigation on behalf of the Assignee under the same fee agreement with the Assignor and/or a revised fee agreement with the Assignee going forward.

Q. How is existing Litigation against the Assignor handled by the Assignee?
A. As a fiduciary, the Assignee is challenged with the economic decision of continuing to defend the Assignment Estate against prosecution of any disputed claim. Key issues to be considered by the Assignee are (a) what is the nature of the dispute between the parties and any overall economic benefit to the Estate to justify the ongoing cost of defense, and (b) the measuring stick often used by the Assignee to evaluate these matters is determining what scenario has the highest probability of creating the largest dividend for creditors.

Q. How and when are funds distributed to creditors in a General Assignment?
A. Proceeds from sale are generally distributed first to secured creditors, then to expenses of administration and then on "priority" claims (mostly taxes and wages) – the same order as in a bankruptcy case. Distributions to unsecured creditors are made on a strict pro-rata basis and can commence anytime after the "bar date" to file claims has passed (usually about six months), subject to resolution of any major disputed asset or liability issues.

Q. Is a General Assignment cheaper and quicker than a Chapter 7, and why?

A. The significant difference stems from the fact that the Assignment is an out of court process. In Chapter 7 it takes weeks before a Bankruptcy Trustee can begin to administer the case. During that time the accounts receivable will deteriorate significantly and the debtor's assets may remain unprotected. Court approval is required to liquidate assets. For these and other reasons, sales by Chapter 7 Trustees usually bring less and cost more than when compared to a General Assignment.

Q. What is probability the overall greatest benefit in making a General Assignment for the Benefit of Creditors as opposed to filing Chapter 7 of the Bankruptcy Code and/or self liquidation.

A. The greatest benefit besides the process itself not being supervised by the court, is the timing in which an Assignee can step into the shoes of the Assignor for purposes of maximizing the value, thereby minimizing exposure on any personal guarantees by either (a) operating the business for a short period of time in order to consummate a bulk sale and realize going concern value for the assets, (b) completing work-in-process before shutting down in order to realize the highest and best value for raw material/finished goods inventory and to minimize back charges against the accounts receivable, (c) maximize collections of accounts receivable by offering incentives to key employees for a short period of time, (d) prior to the Assignment, principals of the Assignor have the ability to meet and agree on a Plan of liquidation that will garner the highest and best price for the assets under an agreed upon written fee agreement and Budget for expenses, and (e) the Assignment is often the perfect bridge between the lender and Debtor, especially if the relationship has become adversarial. Secured lenders generally welcome the involvement of an Assignee in these situations as the lender gets the security of knowing that the Assignee will administer the liquidation of assets and be responsible for the distribution of all proceeds of sale. On the other hand, in agreeing to the Assignment, the principals of the Debtor generally have the opportunity to negotiate pre assignment, payment of certain priority claims such as accrued vacation and any priority tax claims that may effect the officers if not paid. There is no assurance that the Lender will agree to allow the Assignee to use its cash collateral to pay priority claims, however, the Assignment process creates a forum in which those items are generally addressed pre assignment such that the Debtor and lender generally reach some level of agreement on those issues.

GENERAL ASSIGNMENT FOR THE BENEFIT OF CREDITORS

This General Assignment for the Benefit of Creditors ("General Assignment") is made and entered into as of the _____ day of __________, 2021 , (the "Effective Date"), by and between ______________________, Inc., a Delaware corporation, Federal Taxpayer Identification Number : ____________ , located at ___________________________, ("Assignor" and/or "Company") and ABC Services Group, Inc., a Delaware corporation, not individually, but solely in its capacity as ASSIGNEE ("ABC SERVICES" and/or "Assignee") for the benefit of creditors of ________ with respect to the following facts:

RECITALS

WHEREAS, California law including, but not limited to, California Code of Civil Procedures Sections 493.01 0 through 493.060 and Sections 1 800 through 1 802 provide that debtors may make an assignment for the benefit of creditors, pursuant to which the Assignee will liquidate the debtor's assets and in accordance with the requirements of applicable law distribute the proceeds; and

WHEREAS, Assignor has carefully considered the various options available to Assignor to deal with Assignor's creditors, and has decided that it would be in Assignor's best interest and the best interests of Assignor's creditors to make an assignment for the benefit of creditors pursuant to California law; and

WHEREAS, ABC SERVICES is in the business, amongst other matters, of managing and conducting assignments for the benefit of creditors in accordance with California law, and effectuating the sale of the debtor's assets and distribution of the proceeds in accordance with applicable law; and

WHEREAS, Assignor desires to, pursuant to the terms set forth hereinbelow, retain ABC SERVICES for the purposes of making an assignment for the benefit of creditors pursuant to which ABC SERVICES will act as Assignee, liquidate the assets of Assignor, and distribute the proceeds in accordance with applicable law, and ABC SERVICES desires to be so retained pursuant to the terms set forth hereinbelow.

Now, therefore, in consideration of the General Assignment, covenants, conditions, representations and agreements described hereinbelow, Assignor and Assignee agree as follows:

AGREEMENT

1 .0 Assignment of Assets for the Benefit of Creditors. Assignor hereby makes this General Assignment for the benefit of Assignor's creditors to ABC SERVICES as Assignee. Assignor does hereby grant, bargain, sell, assign, convey and transfer unto said Assignee, its successors and assigns, in trust, for the benefit of Assignor's creditors, all of the property of the Assignor of every kind and nature and where so ever situated, both real property (**but not real property lease arrangements**) and personal property, and any interest or equity, including, but not limited to, all that certain stock of merchandise, furniture, fixtures, equipment, book accounts, books, bills receivable, cash on hand, cash in banks, deposits, patents, copyrights, trademarks and trade names and all associated good

will, Intellectual Property, source codes, URLs, or related website rights, social media platforms, software, and related documents, insurance policies, tax refunds, rebates, insurance refunds and claims, choses in action that are legally assignable, together with the proceeds of any existing non-assignable choses in action that may hereafter be recovered or received by the Assignor, to Assignee ("Assignment Estate"). Assignor agrees to execute such additional documents as shall be necessary to assign the Assigned Property (as defined below).

Without limiting the foregoing this General Assignment specifically includes and covers all claims for refund or abatement of all excess taxes heretofore or hereafter assessed against or collected from the Assignor by the U.S. Treasury Department, and any State or local taxing agency, and the Assignor agrees to sign and execute a Power of Attorney attached hereto as "Schedule B" or all other documents as required to enable said Assignee to file and prosecute, compromise and/or settle, all such claims before the Internal Revenue Service and any State or local taxing agency, and agrees to endorse any tax refund checks relating to the prior operations of said Assignor's business and to deliver such checks to the Assignee.

This General Assignment constitutes a Grant Deed to all real property owned by Assignor (except for real property leases and leasehold interests), whether or not the Assignor's real property is specifically described in this General Assignment.

Assignee is to receive said property, conduct said business, should it deem it proper, and is hereby authorized at any time after the signing hereof by Assignor to sell and dispose of said property upon such time and terms as it may see fit, and is to pay to creditors of Assignor pro rata, the net proceeds arising from the conducting of said business and sale and disposal of said property, after deducting all moneys which Assignee may at its option pay for the discharge of any lien on any of said property and any indebtedness which under the law is entitled to priority of payment, and all expenses, including a reasonable fee to Assignee and its attorneys.

Notwithstanding the foregoing, leases and leasehold interests in real estate are not included in this General Assignment. However, if the Assignee shall determine that the same may be assigned and also that the same has a realizable value for creditors, then the Assignor agrees that upon written demand of the Assignee, it will assign and transfer said lease or leasehold interest to said Assignee, or nominee, for administration under the terms of this General Assignment.

All property assigned to Assignee is hereinafter referred to as "Assigned Property". Other than the foregoing, Assignor is not obligated to further assist the Assignee with respect to the General Assignment following the Effective Date, except as otherwise agreed in writing.

Notwithstanding the foregoing, contracts and/or agreements between Assignor and any Labor Union, or Trade Associations and properties exempt from executions are excluded from this General Assignment and are not hereby assigned.

2.0 <u>Certain Acknowledgments Regarding Transfer.</u> Assignor acknowledges that certain of the assets being assigned under this General Assignment may be subject to restrictions on the use or transfer of such assets, the unauthorized use or transfer of which may result in further damages or claims. Such assets may include, without limitation, intellectual property rights of the Assignor (e.g., trade names, service names, registered and unregistered trademarks and service marks and logos; internet domain names; patents, patent rights and applications, therefore, copyrights and registrations and applications therefor; software and source code (and software licenses with respect thereto); customer lists and customer information; know-how, trade secrets, inventions, discoveries, concepts, ideas, methods, processes, designs, formulae, technical data, drawings, specifications, data bases and other proprietary assets (collectively, "Intellectual Property")). Assignor represents and warrants that its officers, directors, shareholders, employees, agents, customers and other third parties have been advised not to use, remove or cause a transfer (other than pursuant to this General Assignment) of any of the assets of Assignor, including without limitation the Intellectual Property, either prior or subsequent to this General Assignment, except as expressly authorized in writing in advance, which written authorization is not inconsistent with or will not otherwise constitute a breach of any other written agreement. Except as authorized in writing, which has been disclosed in writing to Assignee, Assignor further represents and warrants that no asset (including, without limitation, the Intellectual Property) has been transferred, used, or removed in whole or in part, in a manner that interferes with the rights and interests of a third party(ies) in such asset or otherwise may constitute a breach of any contract with such third party(ies).

3.0 Duties of Assignor.

3.1 Mail. Assignor hereby agrees that all postal correspondence is hereby routed to Assignee through Assignee's method of delivery designed in writing by Assignee.

3.2 Creditor List. Assignor shall concurrently herewith furnish to Assignee a true and complete listing of all Assignor's creditors and equity holders including but not limited to name, address, contact information, amount of the claim and a brief description of the claims, together with an affidavit verifying same under penalty of perjury.

4.0 Duties of Assignee.

4.1 Care for Assigned Property. Assignee shall provide commercially reasonable care for the Assigned Property, to the extent that the Assigned Property includes funds and materials necessary to do so.

4.2 Operation of the Business. Assignee may at Assignee's discretion continue to operate the business of Assignee, pending the sale or other liquidation of the Assigned Property. Such operation may include the use of independent contractors retained through an outside service and such other consultants, counsel and advisors as Assignee deems appropriate.

4.3 Conduct of the General Assignment for the Benefit of Creditor. Assignee shall be responsible to conduct this General Assignment for the Benefit of Creditors in accordance with applicable law, including but not necessarily limited to the following:

(a) Within 30 days of the date hereof provide notice to all creditors of the bar date for claims to be filed of not less than 1 50 days and not more than 1 80 days from the date of the notice;

(b) Conduct the orderly disposition of the Assigned Property; and

(c) Distribute the proceeds of the disposition of Assigned Property, less Assignee's fees and expenses, in accordance with applicable legal requirements.

(d) Assignee is to receive the Assigned Property, conduct the said business, should it deem it proper, and is hereby irrevocably authorized at any time after the execution hereof to sell, lease, or otherwise dispose of the Assigned Property upon such time and terms as it may see fit.

(e) Assignee shall use and apply the net proceeds arising from the conducting of said business and from the sale, or lease or other disposition of the Assigned Property as follows:

(1) To deduct therefrom (or to reimburse itself with respect to) all sums which said Assignee may at its option pay for the discharge of any lien on any of the Assigned Property and any indebtedness which under the law is entitled to priority of payment, and all expenses, including a reasonable fee to the Assignee (as hereinafter defined) and to its attorney, and, in those instances where the Assignee has decided in its sole discretion to call a meeting of Assignor's creditors to invite the formation of an advisory creditors' committee (without regard to the actual amount or number of creditors present at such creditors' meeting) then a reasonable fee shall be paid to the attorney appointed by said creditors' committee in an amount fixed by the creditors' committee and Assignee.

(2) The balance of the proceeds then remaining shall be paid to the creditors of the Assignor, pro rata, according to the indebtedness due each of them and their respective priorities as set forth by applicable law, individually, from the Assignor.

5.0 Compensation to Assignee and Reimbursement of Expenses. With respect to the fees of the Assignee referred to in paragraph 4.3(e)(1) hereinabove, Assignor hereby expressly and irrevocably agrees as follows: That the term "a reasonable fee to Assignee", as used herein, is defined as, and includes the following: (a) A minimum fee payable of $____________ shall be paid as a non-refundable deposit concurrently with execution of this assignment, plus and (b) ABC Services hourly rate for services payable on a monthly basis plus actual out-of-pocket expenses, including but not limited, to attorneys, accountants, appraisers, liquidators, real estate brokers, and outside vendors or service provider(s). Reasonable compensation does not replace or subsume the reimbursement of all the Assignee's expenses incurred as a result of the administration of the assignment estate from the proceeds generated therefrom. ABC Services agrees to cap its fee at $_______________ until such time as (secured creditors name) ___________secured claim or any claim subrogated to ________________ secured claim is paid in full. To the extent that all or any portion of the $___________ has been paid to the Assignee by the Assignor same shall be deemed as earned upon receipt as a nonrefundable deposit.

Once the secured claims as stated above are satisfied in full, ABC Services is entitled to a fee of __% of the total monies collected in connection with this General Assignment and for the collection and liquidation of the assets assigned, and (c) a fee of __% shall be charged on any distributions to any priority and general unsecured creditors. The total of all said fees shall be paid from the property assigned, and from all of the proceeds thereof and from any interest, income and increments and any additions thereto. All the aforementioned amounts shall be determined at Assignee's sole discretion and judgment.

6.0 Warranties of Assignee. While having performed preliminary due diligence, Assignee hereby relies upon many representations made by Assignor. Assignee makes no warranties other than the following:

(a) A list of creditors and equity holders has been delivered to Assignee in accord with Section 3.2 along with an affidavit by Assignor's agents verifying same.

(b) Assignor has completed Assignee's pro forma due diligence (or tendered an equivalent version thereof) and has certified that all information provided to the Assignee is true and correct to the best of its knowledge; and

(c) Assignor also warrants that Assignee did not aid in the completion of said documents.

Apart from the receipt of said documents, Assignee makes no warranties or representations regarding Assignor's operations.

7.0 Warranties of Assignor. Assignor represents and warrants to Assignee, acknowledging the Assignee will be relying upon the warranty of Assignor as follows:

(a) Assignor has delivered to Assignee a true and complete list of creditors and equity holders, amounts due to each creditor, and contact information for each creditor, amount of equity held by each equity holder and contact information for each equity holder, along with an affidavit verifying same;

(b) Assignor has correctly and fully completed Assignee's pro forma due diligence (or tendered an equivalent version thereof acceptable in the sole discretion of Assignee) and has certified that all info provided to the Assignee is true and correct to the best of its knowledge;

(c) Assignor also warrants that Assignee did not aid in the completion of the documents referenced in (a) and (b) above;

(d) That this General Assignment has been properly authorized by all appropriate corporate or company actions of Assignor, true and correct copies of which are attached hereto as "Schedule A" and that each of the individual(s) executing this General Assignment on behalf of Assignor are properly authorized to do so;

(e) That all information provided by the Assignor to Assignee with respect to the Assigned Property and/or Assignor's business is true and correct in all material respects and does not fail or omit to state any facts with respect thereto which would be material;

(f) Assignor has all requisite power and authority to execute, deliver and perform its obligations under this General Assignment, including, without limitation, to transfer the Assigned Property;

(g) The execution, delivery and performance by the Assignor of this General Assignment has been duly authorized by all necessary corporate and other action and does not and will not require any registration with, consent or approval of, or notice to or action by, any person (including any governmental authority) in order to be effective and enforceable; and

(h) This General Assignment constitutes the legal, valid and binding obligations of the Assignor, enforceable against Assignor in accordance with its terms.

8.0 Limitations on Liability of Assignee. Assignor acknowledges that Assignee is acting solely as Assignee in connection with this General Assignment and not in its personal capacity. As a result, Assignor expressly agrees that Assignee, its members, officers, employees, directors, contractors, attorneys and agents shall not be subject to any personal liability whatsoever to any person in connection with the affairs of this General Assignment, except for its own gross negligence and misconduct knowingly and intentionally committed in bad faith. No provision of this General Assignment shall be construed to relieve the Assignee from liability for its own gross negligence and misconduct knowingly and intentionally committed in bad faith, except that:

(a) The Assignee shall not be required to perform any duties or obligations except for the performance of such duties and obligations as are specifically set forth in this General Assignment, and no implied covenants or obligations shall be read into this General Assignment against the Assignee;

(b) In the absence of bad faith on the part of the Assignee, the Assignee may conclusively rely, as to the truth, accuracy and completeness thereof, on the statements and certificates or opinions furnished to the Assignee by the Assignor and conforming to the· requirements of this General Assignment;

(c) The Assignee shall not be liable for any error of judgment made in good faith;

(d) The Assignee's maximum liability under all circumstances shall be limited to the total amount of fees received.

In connection with the foregoing, the Assignment Estate shall defend, indemnify and hold the Assignee and its past and present officers, members, managers, directors, employees, counsel, agents, attorneys, parent, subsidiaries, affiliates, successors and assigns, (collectively and each, the "Indemnified Persons" or "Indemnified Person") harmless from and against any and all liabilities, obligations, losses, damages, penalties, actions, judgments, suits, costs, charges, expenses and disbursements (including reasonable attorneys' fees and costs) of any kind or nature whatsoever which may at any time be imposed on, incurred by, or asserted against any such Indemnified Person in any way relating to or arising out of this General Assignment, any other document contemplated by or referred to herein or therein, the transactions contemplated hereby or thereby, or any action taken or omitted by any Indemnified Person under or in connection with any of the foregoing, including, without limitation, with respect to any investigation, litigation or proceeding related to or arising out of any of the foregoing, whether or not any Indemnified Person is a party thereto, and including, without limitation, any other Indemnified Claims (defined below) provided, that the Assignment Estate shall have no obligation hereunder to any Indemnified Person with respect to Indemnified Claims to the extent resulting from the willful misconduct or gross negligence of any Indemnified Person. The foregoing indemnification shall survive any termination of this General Assignment or the transactions contemplated hereby. For purposes hereof, "Indemnified Claims" means any and all claims, demands, actions, causes of action, judgments, obligations, liabilities, losses, damages and consequential damages, penalties, fines, costs, fees, expenses and disbursements (including without limitation, fees and expenses of attorneys and other professional consultants and experts in connection with investigation or defense) of every kind, known or unknown, existing or hereafter arising, foreseeable or unforeseeable, which may be imposed upon, threatened or asserted against, or incurred or paid by, any Indemnified Person at any time and from time to time, because of, resulting from, in connection with, or arising out of any transaction, act, omission, event or circumstance in any way connected with this General Assignment, any other document contemplated by or referred to herein or therein, the transactions contemplated hereby or thereby, or any action taken or omitted by any Indemnified Person under or in connection with any of the foregoing, including but not limited to economic loss, property damage, personal injury or death in connection with, or occurring on or in the vicinity of, any assets of the Assignment Estate through any cause whatsoever, any act performed or omitted to be performed under this General Assignment, any other document contemplated by or referred to herein, the transactions contemplated hereby, or any action taken or omitted by any Indemnified Person under or in connection with any of the foregoing, any breach by Assignor of any representation, warranty, covenant, agreement or condition contained herein or in any other agreement between Assignor and Assignee.

9.0 Reliance.

(a) The Assignee may rely and shall be protected in acting upon any resolution, certificate, statement, instrument, opinion, report, notice, request, consent, order, or other paper or document believed by it to be genuine and to have been signed or presented by the proper party or parties.

(b) The Assignee may consult with legal counsel to be selected by it, and to the extent allowable by law, the Assignee shall not be liable for any action taken or suffered by it in accordance with the advice of such counsel; and

(c) Persons dealing with the Assignee shall look only to the Assignment Estate to satisfy any liability incurred by the Assignee in good faith to any such person in carrying out the terms of this General Assignment, and the Assignee shall have no personal or individual obligation to satisfy any such liability.

1 0.0 Resignation and Replacement of Assignee. The Assignee may resign and be discharged from its duties hereunder at any time; provided that such resignation shall not become effective until a successor Assignee has been appointed by the resigning Assignee and such successor has accepted its appointment in writing delivered to the resigning Assignee. Any successor Assignee appointed hereunder shall execute an instrument accepting such appointment hereunder and shall deliver one counterpart thereof to the resigning Assignee. Thereupon such

successor Assignee shall, without any further act, become vested with all the estate, properties, rights, powers, trusts, and duties of his predecessor in connection with the General Assignment with like effect as if originally named therein, but the resigning Assignee shall nevertheless, when requested in writing by the successor Assignee, execute and deliver an instrument or instruments conveying and transferring to such successor Assignee all of the estates, properties, rights, powers and trusts of such resigning Assignee in connection with the General Assignment, and shall duly assign, transfer, and deliver to such successor Assignee all property and money held by it hereunder.

1 1 .0 Miscellaneous Provisions

(a) Governing Law, Jurisdiction and Venue. This General Assignment shall be construed under and in accordance with the laws of the State of California, including but not limited to Statute of Limitations laws. The state courts of California shall exercise jurisdiction with respect to any dispute hereunder, and the parties agree that the proper venue for any such dispute shall be in Orange County, State of California.

(b) Construction. This General Assignment is to be viewed as having been drafted jointly by the parties and is not to be construed for or against any of the parties.

(c) Duplicate Counterparts. This General Assignment may be executed in duplicate counterparts, each of which shall be deemed to be an original; provided, however, such counterparts shall together constitute only one instrument.

(d) Severability. If any provision of this General Assignment or any portion of any provision of this General Assignment shall be deemed to be invalid, illegal or unenforceable, such invalidity, illegality or unenforceability shall not alter the remaining portion of such provision, or any other provision hereof, as each provision of this General Assignment shall be deemed severable from all other provisions hereof.

(e) No Third-Party Beneficiary. No term or provision of this General Assignment or the schedules hereto is intended to be, nor shall any such term or provision be construed to be, for the benefit of any person, firm, corporation or any other entity not a party hereto (including, without limitation, real estate brokers and finders), and no such other person, firm, corporation or entity shall have any right or cause of action hereunder.

(f) Time of Essence. Time is expressly made of the essence as to the performance of each and every obligation and condition of this General Assignment.

(g) Notices. Any notice or other communication provided for herein or given hereunder to a party hereto must be in writing addressed to the respective party's address listed below, and shall be deemed received upon: (i) actual receipt, or (ii) 24 hours of receipt by receiving party after being sent by facsimile (with "answerback" confirmation of facsimile transmission) or electronic mail, or (iii) by overnight delivery by major recognized carrier with written verification of receipt by receiving party or, (iv) five (5) days after sent by Certified Mail, Return Receipt Requested. Each such notice, request or consent shall be deemed effective upon same being 'received' in the fashion as defined above.

To Assignee — ABC Services Group, Inc.
695 Town Center Drive, Suite 650,
Costa Mesa, CA 92626
Attention: Charles Klaus, President
Tel. No.: (949) 922-
1 21 1
Fax No.: (888) 400-1 699
Email: chuck@ABCservices.group

To Counsel to Assignee

To Assignor: ______________________**, Inc.**

Attn:
Tel. No.
Email:

To Counsel to Assignor __________________________

Either party may change its address for notice purposes by giving notice in the manner set forth in this Section.

(h) Headings. The headings of this General Assignment are for the purpose of reference only and shall not limit or define the meaning hereof.

(i) Attorney Fees. If there is any dispute between the Parties with respect to the Assigned Property, this General Assignment, the performance of the obligations hereunder or the effect of a termination under this General Assignment, the prevailing party shall be paid all costs and expenses incurred by the other party in connection with such proceedings, including reasonable attorneys' fees (including fees for the service of salaried attorneys regularly employed by a party) and costs. The parties agree that each of them shall bear its own legal costs and expenses in connection with the negotiation, drafting, and execution of this General Assignment.

(j) No Waiver. A waiver by either party of a breach of any of the covenants, conditions or obligations under this General Assignment to be performed by the other party shall not be construed as a waiver of any succeeding breach of the same or other covenants, conditions or obligations of this General Assignment.

(k) Entire Agreement. This General Assignment constitutes the entire agreement between the Parties. This General Assignment may not be amended or modified except by an amendment in writing signed by the handwritten signature of each party. Without limiting the foregoing no exchange of emails shall serve to amend this General Assignment.

11.0 No Adequate Remedy at Law. Each party hereto acknowledges and agrees that damages will not adequately compensate the other party for a breach of the terms of this General Assignment and that, as such, each party shall be entitled to specific performance of this General Assignment.

12.0 Arbitration. All disputes, claims and controversies, including and not limited to all other matters including breach of fiduciary duty, breach of contract, negligence or other tort claims (intentional or unintentional) and/or declaratory or other equitable relief arising under or concerning the performance of this General Assignment shall be submitted to binding arbitration pursuant to the provisions of California Code of Civil Procedure 1282 through 1284.2, inclusive, before one (1) retired California judge or justice selected by agreement of the parties, or from the Business Civil Litigation Panel of Attorneys published by the Administrator for Orange County Arbitration. If the parties cannot agree upon an arbitrator within ten days after any party demands arbitration, then JUDICATE WEST shall provide the names of three available retired judges on its staff and each party shall be entitled to strike one name. The remaining judge shall be the selected arbitrator. If either side refuses to strike an arbitrator within ten days from the service of the names of the arbitrators, then JUDICATE WEST shall decide which of the remaining two shall be selected. The findings, order or award of the arbitrator may thereafter be entered as a judgment upon petition to the Orange County Superior Court. It shall be a condition precedent to the subject matter jurisdiction of any court of the State of California that any such disputes, controversies and actions arising out of this agreement or of any services performed as a result of this agreement, including, without limitation, the scope and extent of the issues to be arbitrated, shall first have been determined by arbitration. You understand and agree that by consenting to arbitrate all disputes and controversies you agree to waive trial by jury.

____
Assignor initials approving
arbitration provision

[Signatures on next page]

In witness whereof, the parties have executed this General Assignment sufficient to bind themselves as of the date first above written.

______________________, a _________ corporation	ABC Services Group, Inc., a Delaware corporation
___________________________________ By:	___________________________________ By: Charles Klaus
Its: Chief Executive Officer	Its: President

SCHEDULE A

CONSENT OF DIRECTORS TO HOLD MEETING

MINUTES OF THE MEETING

CONSENT TO ASSIGNMENT BY STOCKHOLDERS

CONSENT OF DIRECTORS TO HOLD MEETING

City, State, Zip Dated: _____, 2021

We, the undersigned, being all the directors of ______________________, Inc., a __________ corporation organized under the laws of the State of Delaware, assembled this day at ________, California, do hereby consent that a meeting of said directors be held at this time and place for the transaction of such business as may come before the meeting, and waive any notice of said meeting.

NAME	SIGNATURE
______________________	______________________
______________________	______________________
______________________	______________________

MINUTES OF THE MEETING

City, State, Zip Dated: ___, 2021

At a meeting of the directors of ______________________, a ______ corporation, held at the office of the Company at ____________, California, at _________________ AM/PM, the following directors were present:

______________________ ______________________

______________________ ______________________

______________________ ______________________

Absent:

______________________ ______________________

______________________ ______________________

______________________ ______________________

The President announced that the purpose of the meeting was to consider the financial condition of the company and the advisability of making a general assignment for the benefit of creditors.

On a motion made by ______________, the following resolution was adopted, to-wit:

BE IT RESOLVED:

That any of the officers of this corporation be, and is hereby authorized and directed by the directors of this company, in meeting assembled, to make an assignment of all assets of the corporation to ABC Services Group, Inc., a Delaware corporation, of Tustin, California, for the pro rata benefit of all creditors of this corporation, and that any officer is hereby authorized and directed to execute said assignment containing such provisions as may be agreed upon between them and said ABC Services Group, Inc., a Delaware corporation (Assignee), and is also authorized and directed to execute and deliver to said ABC Services Group, Inc., a Delaware corporation (Assignee), such other deeds, assignments, and agreements as may be necessary to carry this resolution into effect.

BE IT FURTHER RESOLVED:

That said assignee for the benefit of creditors be, and it hereby is, authorized to execute and file and prosecute on behalf of this corporation all claims for refund or abatement of all excess taxes heretofore or hereafter assessed against or collected from this corporation and any one officer of this corporation be, and it is, hereby authorized and directed to make, execute and deliver in favor of such person as may be designated by the assignee for the benefit of creditors, a power of attorney on the regular printed form thereof used by the United States Treasury Department so as to authorize said attorney-in-fact to process any tax claims for it on behalf of this corporation.

There being no further business to come before the directors, the meeting adjourned subject to the call of the President.

____
__________________, Chief Executive Officer

I, ________________, Chief Executive Officer of ______________________, Inc., a ______________ corporation, do hereby certify that the foregoing is a true and correct copy of the minutes of the meeting of directors held in _________, California, at the place and hour stated and that the resolution contained in said minutes was adopted by the directors at said meeting and the same has not been modified or rescinded.

Dated: ____________, 2021

____

___________, Chief Executive Officer

CORPORATE

SEAL

CONSENT TO ASSIGNMENT BY STOCKHOLDERS

We, the undersigned, being owners and holders of shares of stock, being more than 50% of the subscribed and issued stock of _______________________, Inc., a ____________ corporation, do hereby give our consent to the within assignment and transfer of the property of said corporation.

			Ownership	Signed
Shareholder	Share Type	Shares	Percentage	Consent

SCHEDULE B

POWER OF ATTORNEY

POWER OF ATTORNEY

_____________________, Inc., a ___________ Corporation ("Company"), is the Assignor under that certain Assignment for the Benefit of Creditors, dated as of _____, __, 2021 (the "Assignment"), by and between the Company and ABC Services Group, Inc., a Delaware corporation ("ABC SERVICES").

WHEREAS, pursuant to the Assignment, the Company is assigning substantially all of its assets to ABC SERVICES to be administered, liquidated and distributed by ABC SERVICES as described therein;

NOW, THEREFORE, in order for ABC SERVICES to fully effectuate the Assignment and each of the other transactions contemplated thereby, the Company hereby appoints ABC SERVICES its attorney-in-fact and hereby grants to such attorney-in-fact full power and authority to do and perform any and every act and thing whatsoever requisite, necessary, or proper to be done in the exercise of any of the rights and powers herein granted, hereby ratifying and confirming all that such attorney-in-fact shall lawfully do or cause to be done by virtue of this Power of Attorney and the rights and powers herein granted. ABC SERVICES, acting through any one of its duly appointed officers, and with full power of attorney in the name of, and for and on behalf of the Company, may execute, acknowledge, deliver, and record any document or process required to effectuate the Assignment, including but not limited to:

(1) such transfer powers, deeds, bills of sale, assignments of leases, assignments of liens, assignment of notes, assignments of any other assets whatsoever, memoranda of assignments, and such other instruments of transfer and assignment and releases as ABC SERVICES shall determine to be necessary or appropriate to consummate or to provide notice of the transfer of any or all of the Company's assets to ABC SERVICES pursuant to the Assignment, in form and substance satisfactory to ABC SERVICES, with the execution, acknowledgment, delivery and/or recordation thereof by ABC SERVICES to constitute evidence of such determination and ABC SERVICES's satisfaction thereof;

(2) such other documents, certificates, receipts, notices, instructions, statements and other writing as ABC SERVICES shall determine to be necessary or appropriate in connection with or to carry out the administration or transfer of the Company' assets as contemplated by the Assignment, in form and substance satisfactory to ABC SERVICES, with the execution, acknowledgment, delivery and/or recordation thereof by ABC SERVICES to constitute evidence of such determination and ABC SERVICES's satisfaction thereof;

(3) any amendments to the documents of transfer delivered in connection with the transfer or administration of the Company's assets as contemplated by the Assignment, as ABC SERVICES shall determine to be necessary or appropriate to vest full right, title and interest of the Company in and to the Company's assets in ABC SERVICES pursuant to the terms of the Assignment, in form and substance satisfactory to ABC SERVICES, with the execution, acknowledgment, delivery and/or recordation thereof by ABC SERVICES to constitute evidence of such determination and ABC SERVICES's satisfaction thereof; and

(4) such other documents, certificates, receipts, notices, instructions, statements and other writing as ABC SERVICES shall determine to be necessary or appropriate in connection with or to obtain any refund or abatement of excess taxes heretofore or hereafter assessed against or

collected from the Company by the U.S. Treasury Department, and any State or local taxing agency; and

(5) such other documents, certificates, receipts, notices, instructions, statements and other writing as ABC SERVICES shall determine to be necessary or appropriate in connection with the administration of employee benefit and retirement programs.

ABC SERVICES is hereby empowered to determine in its sole discretion the time or times when, the purpose for and the manner in which any power herein conferred upon it shall be exercised, and the conditions, provisions or covenants of any instrument or document which may be executed by it pursuant hereto. ABC SERVICES is further empowered take any other action of any type whatsoever in connection with the foregoing which, in the opinion of ABC SERVICES, may be of benefit to, in the best interest of, or legally required to be performed by, the Company. ABC SERVICES may file and prosecute, compromise and/or settle, all claims before the Internal Revenue Service and any State or local taxing agency as contemplated by the Assignment.

The foregoing is made for the benefit of, and may be relied upon by, ABC SERVICES, its successor, assigns, agents and representatives.

This Power of Attorney shall be governed by the laws of the State of California, without regard to choice of law principles.

IN WITNESS WHEREOF, the undersigned has executed this Power of Attorney this ______ day of December 2021, to be effective as of such date.

______________________, Inc., a __________Corporation

By: __________________________

__________Chief Executive Officer

Affidavit

Attached hereto is a complete list of the creditors and equity holders of _______________, Inc., which list includes names, addresses, cities, states, zip codes, together with the anticipated claim for each creditor of the Assignment Estate.

I declare under penalty of perjury under the laws of the State of California that the information contained in the attached list is true and correct to the best of my knowledge.

Dated: ________, 2021

Debtor Company, Inc.,

____

Joe Debtor, President

Not Reported in Cal.Rptr.3d, 2011 WL 5910059 (Cal.App. 4 Dist.)
Nonpublished/Noncitable (Cal. Rules of Court, Rules 8.1105 and 8.1110, 8.1115)
(Cite as: 2011 WL 5910059 (Cal.App. 4 Dist.))

Only the Westlaw citation is currently available.

California Rules of Court, rule 8.1115, restricts citation of unpublished opinions in California courts.

Court of Appeal, Fourth District, Division 3, California.
Haitham EL SAAD et al., Plaintiffs and Respondents,
v.
Mike TARAKJI et al., Defendants and Appellants.

No. G044716.
(Super.Ct.No. 30–2009–00121128).
Nov. 28, 2011.

Appeal from a judgment of the Superior Court of Orange County, John C. Gastelum, Judge. Affirmed.
Jason Dilday for Defendants and Appellants.

Wellman & Warren, Scott W. Wellman and Derek Banducci, for Plaintiffs and Respondents.

OPINION

BEDSWORTH, Acting P.J.

***1** After a court trial, appellants Mike Tarakji, Ernest Tarakji, Manal Tarakji, Omar Salahieh, Platinum Touch Entertainment, LLC, and United Telecom & Technologies, Inc., were found liable to Haithem El Saad and Callcom, Inc. (collectively Callcom), based upon their participation in a conspiracy to fraudulently transfer the assets of West Coast Distribution, Inc., (hereafter West Coast) with the intention to hinder, delay or defraud its creditors.

Appellants argue the evidence was insufficient to support several of the court's findings in support of the judgment, including its finding that West Coast's assets were transferred to Platinum Touch; that any party had the intention to hinder, delay or defraud West Coast's creditors; and that Callcom's interest as a creditor of West Coast was harmed by the alleged transfer. Appellants also contend the court failed to provide a sufficient basis for imposing conspiracy liability on them, and that the court arbitrarily rejected the testimony which supported their position.

We affirm the judgment. The trial court provided the parties with a lengthy and detailed statement of decision, which explained both the court's assessment of the evidence and its application of the governing law. Although the statement purports to identify only seven material facts,—which, taken together, simply establish a timeline of events—the statement is rife with additional factual determinations, both express and implied. And on appeal, we are required to draw all reasonable inferences which can be gleaned from the evidence *in favor of* the court's decision. Appellants have largely ignored that rule in their opening brief, choosing instead to quibble with minor facts mentioned in the court's statement of decision, and to reargue—in isolation—the aspects of the evidence which they believe support their own position. That approach to challenging the sufficiency of the judgment is doomed to fail on appeal.

Appellants' challenge to the court's imposition of conspiracy liability is similarly flawed. Again, appellants ask us to focus on specific details of the court's decision, without acknowledging the broader picture or the obvious inferences to be drawn from their course of conduct. Moreover, appellants' specific complaints about the sufficiency of the court's findings are unpersuasive, to say the least.

Finally, the court was free to disbelieve the witnesses who testified to the innocence of appellants' conduct because that claim of innocence was contradicted by obvious and fairly compelling inferences deducible from the evidence before it. We certainly cannot say the court erred in doing so.

FACTS

On February 5, 2009, Callcom obtained a jury verdict for fraud against West Coast, a distributor of telephone calling cards, in the sum of $3,992,218.48. Eight days later, on February 13, 2009, appellant Platinum Touch Entertainment, LLC, was formed, with Salahieh as its principal.

On February 24, 2009, judgment was entered in favor of Callcom in the fraud case, and Callcom quickly served notice of a motion for assignment of West Coast's accounts receivable in partial satisfaction of its judgment.

***2** On March 6, 2009, three days after Callcom filed its motion for assignment, West Coast transferred all its assets to Alternative Bankruptcy Concepts, Inc. (hereafter ABC), in exchange for $1, in what was characterized as a "general assignment for the benefit of creditors." [FN1] ABC agreed to act as the assignee on behalf of West Coast's creditors in exchange for a fee of $20,000.

FN1. As explained in *Credit Managers Assn. v. National Independent Business Alliance* (1984) 162 Cal.App.3d 1166, 1169: "An assignment for [the] benefit of creditors is a business liquidation device available to an insolvent debtor as an alternative to formal bankruptcy proceedings." The assignee in a "general assignment for benefit of creditors" essentially stands in the shoes of a bankruptcy trustee.

Three days after that—on March 9, 2009—and without any party giving notice to Callcom, Alternative Bankruptcy Concepts sold West Coast's assets to Platinum Touch for $20,000 in cash—the exact amount of ABC's fee, which ABC retained. Thus, the net amount ultimately generated by the "general assignment" scheme, which disposed of the entirety of West Coast's assets, was $1. However, as part of the second transaction, between ABC and Platinum Touch, the latter also agreed to assume liability for a purported "secured lien" in the amount of $4.7 million, against the assets of West Coast.

On March 16, 2009, a week after Platinum Touch became the owner of West Coast's assets, Callcom filed its complaint alleging that appellants had wrongfully conspired to transfer West Coast's assets in an effort to hinder, delay or defraud its creditors.

Appellants Mike Tarakji and Ernest Tarakji are principals and shareholders of West Coast, and their sister, appellant Manal Tarakji, is also a shareholder. Each of them signed a written consent to the general assignment of West Coast's assets to ABC, after it had already been agreed Platinum Touch would purchase the entirety of those assets from ABC. After ABC sold the West Coast assets to Platinum Touch, Mike and Ernest Tarakji signed consulting agreements with Platinum Touch.

Appellant Salahieh, the owner of appellant Platinum Touch, is also a former employee of West Coast, and the brother-in-law of Stephan Tarakji. Stephan Tarakji is, in turn, a former shareholder of West Coast, the head of its accounting team, and the brother of appellants Mike, Ernest, and Manal Tarakji. [FN2]

FN2. Stephan Tarakji agreed to sell his 25 percent interest in West Coast in December of 2008, for $230,000.

United Telecom & Technologies, Inc., is the company which was the telecommunications carrier for West Coast's calling cards. United Telecom had an FCC license, and maintained the direct relationship with wholesale suppliers including a company known as NetIP—the holder of the purported $4.7 million secured lien against West Coast's assets. The UCC financing statement offered as evidence of the lien against West Coast's assets identifies the debtor as "West Coast Distribution, Inc., dba United Telecom and Technologies, Inc.," even though the two are separate companies, and West Coast never did business under United Telecom's name.

At trial, Callcom argued that the events and circumstances outlined above, which are undisputed, evidenced a conspiracy to hinder and defraud West Coast's creditors (and specifically Callcom), by arranging to transfer its assets for essentially no consideration to a new entity (Platinum Touch) which then contracted with West Coast's former owners and principals to reassume control of the business. Callcom offered evidence that West Coast's business had a value significantly in excess of the $20,000 paid by Platinum Touch, and it challenged the validity of the purported $4.7 million secured lien. Specifically, Callcom argued there was no actual evidence supporting the assertion that the lien amount was $4 .7 million—the UCC filing which allegedly perfected the lien stated no amount—and no evidence of any underlying agreement between West Coast and NetIP which might have supported the creation or existence of such a significant debt owed by West Coast.

***3** Appellants asserted their actions were entirely innocent, that the decision to make a general assignment of West Coast's assets for the benefit of its creditors was simply a function of the business' decline, and represented a better option than a liquidation of the company's assets in a bankruptcy proceeding. They argued the company had no net value, given the existence of the $4.7 million secured lien, and thus none of West Coast's unsecured creditors (such a Callcom) could have been harmed by the transfer of its assets.

The trial court ruled in favor of Callcom, and explained, in a lengthy and detailed statement of decision, its evaluation of the evidence and its application of the law. The court explained, among other things, that it viewed appellants' version of events as lacking in credibility, and it specifically singled out the testimony offered by appellants Ernest Tarakji and Omar Salaheih, as well as that of the attorney/owner of ABC (who devised the scheme to dispose of West Coast's assets and helped to carry it out) as “not credible, to say the least.”

I

Our record in this case is something less than spare. It does not include a copy of the complaint. However, both sides seem to agree that appellants' liability was based upon a conspiracy to violate the Uniform Fraudulent Transfer Act (UFTA) (Civ.Code, §§ 3439, et seq.) “A fraudulent conveyance under the UFTA involves “ ‘a transfer by the debtor of property to a third person undertaken with the intent to prevent a creditor from reaching that interest to satisfy its claim.’ “ (*Kirkeby v. Superior Court* (2004) 33 Cal .4th 642, 648.) ‘A transfer made ... by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made, if the debtor made the transfer as follows: [¶] (1) With actual intent to hinder, delay, or defraud any creditor of the debtor.’ ([Civ.Code,] § 3439.04, subd. (a).)” (*Filip v. Bucurenciu* (2005) 129 Cal.App.4th 825, 829.)

Civil Code section 3439.04 states that in determining whether a defendant had “actual intent to hinder, delay, or defraud” a creditor, “consideration *may be given,* among other factors, to any or all of the following: [¶] ... [¶] (3) Whether the transfer or obligation was disclosed or concealed. [¶] (4) Whether before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit. [¶] (5) Whether the transfer was of substantially all the debtor's assets. [¶] ... [¶] (8) Whether the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred. [¶] (9) Whether the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred [and] (10) Whether the transfer occurred shortly before or shortly after a substantial debt was incurred.”

Moreover, Civil Code section 3439.05 states: “A transfer made or obligation incurred by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made or the obligation was incurred if the debtor made the transfer or incurred the obligation *without receiving a reasonably equivalent value in exchange for the transfer or obligation* and the debtor *was insolvent at that time or ... became insolvent as a result of the transfer or obligation.*” (Italics added.)

II

***4** Appellants' primary contention on appeal is that the evidence is insufficient to support a determination in Callcom's favor on three of the five findings the court made in determining their liability for fraudulent transfer. Specifically, appellants claim there is insufficient evidence to support the court's determinations that (1) West Coast transferred any assets *to Platinum Touch;* (2) the assets were transferred with actual intent to hinder, delay or defraud West Coast's creditors; and (3) Callcom was harmed by that transfer.

The primary problem with this attack on the sufficiency of the evidence is that it has been launched without acknowledging the heavy burden imposed on an appellant who does so.

“An appellate court “ ‘must *presume* that the record contains evidence to support every finding of fact....’ “ (*In re Marriage of Fink* (1979) 25 Cal.3d 877, 887, italics added; see *Brown v. World Church* (1969) 272 Cal.App.2d 684, 690, [“ ‘a reviewing court starts with the presumption that the record contains evidence to sustain every finding of fact’ “].) It is the appellant's burden, not the court's, to identify and establish deficiencies in the evidence. (*Brown v. World Church, supra,* 272 Cal.App.2d 684, 690.) This burden is a ‘daunting’ one. (*In re Marriage of Higinbotham* (1988) 203 Cal.App.3d 322, 328–329.) ‘A party who challenges the sufficiency of the evidence to support a particular finding must *summarize the evidence* on that point, *favorable and unfavorable, and show how and why it is insufficient* . [Citation.]’ (*Roemer v. Pappas* (1988) 203 Cal.App.3d 201, 208, italics added.) ‘[W]hen an appellant urges the insufficiency of the evidence to support the findings it is his duty to set forth a fair and adequate statement of the evidence which is claimed to be insufficient. He cannot shift this burden onto respondent, nor is a reviewing court required to undertake an independent examination of the record when appellant has shirked his responsibility in this respect.' (*Hickson v. Thielman* (1956) 147 Cal.App.2d 11, 14–15.)" (*Huong Que, Inc. v. Luu* (2007) 150 Cal.App.4th 400, 409.)

Moreover, "[i]t is the duty of the appellant to present an adequate record to the court from which prejudicial error is shown. (*Null v. City of Los Angeles* (1988) 206 Cal.App.3d 1528, 1533.)" (*Kurinij v. Hanna & Morton* (1997) 55 Cal.App.4th 853, 865.) In the case of an attack on the sufficiency of the evidence, that record must include the entirety of the evidence admitted a trial. We cannot conclude the evidence admitted was insufficient to support some necessary finding unless the entirety of that evidence is before us.

Appellants in this case have failed to satisfy either their obligation to summarize and analyze all of the available evidence pertaining to the issues they raise, or their obligation to provide a complete evidentiary record. Specifically, we have not been provided with the exhibits admitted into evidence at trial, and thus we are in no position to reach any conclusions about the sufficiency of the evidence before the trial court.

***5** But even if we were to assume the trial exhibits add nothing significant to the trial record, that assumption would not be enough to save appellants here, because their presentation of the testimonial evidence admitted at trial is quite one-sided, and thus amounts to nothing more than an effort to establish that the court *could* have ruled in their favor on the evidence presented, had it been persuaded to do so.

But that's not the test. Having failed to demonstrate that the evidence *as a whole* is actually insufficient to support the judgment rendered, appellants cannot prevail on their evidentiary claim.

Nor can appellants prevail by simply challenging details included in the court's statement of decision, which is essentially what they have done here. For example, appellants challenge the court's determination that West Coast transferred property *to Platinum Touch,* claiming that the evidence establishes only that West Coast made a "general assignment for benefit of creditors" to ABC, and pointing out that such an assignment is a legally sanctioned alternative to a liquidation of assets in bankruptcy. In making that assertion, appellants seem to be implying that merely because West Coast disposed of its assets in a presumptively legitimate way, no inference of wrongdoing can be drawn, and they cannot be held responsible for what happened to the assets after that. The assertion is disingenuous at best.

According to the facts stated in appellants' own opening brief, the decision to make the general assignment came only after the attorney/principal of ABC informed West Coast's officers that such an assignment would be possible only if NetIP, the purported beneficiary of West Coast's secured lien, consented to the transaction. NetIP, in turn, stated it would do so only if West Coast located a suitable buyer for the assets—i.e., Platinum Touch.

So it was only after all parties had agreed that West Coast's assets would ultimately be transferred, intact, *to Platinum Touch,* that West Coast secured the consent of its majority shareholders (Mike, Ernest and Manal Tarakji) to the general assignment, and the transfer of the assets to ABC was accomplished. The pre-existing agreement that ABC would transfer West Coast's assets to Platinum Touch is obviously why that second transaction was able to be completed in only a few days.

The obvious inference to be drawn from these facts is that it was at all times understood that ABC would simply be acting as the middle-man for a transfer of assets from West Coast to Platinum Touch. Further, although a "general assignment for benefit of creditors" is a business *liquidation* procedure (*Credit Managers Assn. v. National Independent Business Alliance, supra,* 162 Cal.App.3d at p. 1169), and it requires that certain procedures be adhered to for the *protection of the creditors,* this case involved neither liquidation of West Coast's business nor adherence to those procedures.[FN3] Indeed, it seems pretty clear that the general assignment procedure utilized in this case, which resulted in the complete disposition of West Coast's assets to a pre-arranged buyer within a mere three days, was nothing more than a smokescreen for the pre-arranged sale of an existing business. These circumstances are more than sufficient to support the inference that the real transfer of assets in this case was between West Coast and Platinum Touch.[FN4]

FN3. Specifically, Code of Civil Procedure section 1802 requires that "(a) [i]n any general assignment for the benefit of creditors, as defined in Section 493.010, the assignee shall, within 30 days after the assignment has been accepted in writing, *give written notice of the assignment to the assignor's creditors, equityholders, and other parties in interest* as set forth on the list provided by the assignor pursuant to subdivision (c) .... [¶] (b) *In the notice given ..., the assignee shall establish a date by which creditors must file their claims to be able to share in the distribution of proceeds of the liquidation of the assignor's assets* . That date shall be not less than 150 days and not greater than 180 days after the date of the first giving of the written notice to creditors and parties in interest." (Italics added.)

Clearly, Civil Code section 1802 is designed to ensure that the assignee gives notice to all identified creditors *before* proceeding with the disposition of the debtor's property. Moreover, Civil Code section 1802 makes it clear that the distribution of the proceeds of the debtor's property cannot happen for at least 150 days after the creditors have been notified. Moreover, like the trustee in a bankruptcy case, the assignee has a duty to "marshal and protect the assets of [the assignor], which may include filing and defending lawsuits." (*Sherwood Partners, Inc. v. EOP–Marina Business Center, L.L.C.* (2007) 153 Cal.App.4th 977, 983.) In other words, the assignee for the benefit of creditors is obligated to follow formal procedures, and consider the interests and claims of all creditors before disposing of the debtor's property. Clearly, this means the assignee cannot simply make a deal in advance of the general assignment, to dispose of the debtor's property to a designated third party—even if that third party were chosen by the debtor's primary creditor—without providing notice to *anyone else,* as occurred in this case.

FN4. Appellants challenge the trial court's description of the asset transfer as either a "straw man" transaction, with ABC playing the role of the straw man, or as two separate fraudulent transactions. Appellants claim the court could not draw such a conclusion because "there was not even the suggestion of fraud on the part of [ABC] during the trial." We disagree. Even assuming nobody made that charge explicitly during the trial that does not mean the suggestion was not there. The inference that ABC was in cahoots with appellants to accomplish a fraudulent transfer designed to hinder Callcom's collection of its judgment is nearly unavoidable. It is practically inconceivable that an actual assignee *for the benefit of creditors* would agree, in advance of the assignment, to transfer the entirety of a debtor's assets to a third party—for nominal consideration—without ever notifying those creditors or giving them an opportunity to question the debtor's own negative characterization of its net value, or its chosen buyer. But if appellants are to be believed, that's exactly what ABC agreed to do here.

***6** Appellants also challenge the court's determination that the transfer of West Coast's assets was accomplished with actual intent to hinder, delay or defraud West Coast's creditors. And again, we are unpersuaded by their challenge. In essence, appellants are simply arguing that the inferences drawn by the trial court from the evidence presented were not the most compelling of the available options, and thus the court should not have drawn them. But if the inferences drawn by the court were reasonable—and in this case they certainly were—it does appellants no good to argue that alternative inferences were also available.

In any event, we could not agree that appellants' version of events is the most plausible one. Sure, it's *possible* that the plan to dispose of West Coast's assets immediately following the entry of the fraud judgment in favor of Callcom was an innocent quirk of timing. It's also *possible* that appellants had no concern about Callcom's mere notice of motion for an assignment of West Coast's accounts receivable, since, as appellants put it, that notice did nothing more than announce "a future hearing that may or may not have meant anything." But those possibilities seem fairly remote and implausible. Moreover, even if West Coast had not actually received that notice of motion (which it points out was served *by mail*) prior to the execution of its general assignment of assets, it makes little difference. A *fraud judgment had been entered* against West Coast, and any reasonable party in that position would have had ample reason to anticipate a prompt effort by plaintiff to secure payment. West Coast must have understood that its assets were subject to imminent attack by Callcom.

Similarly, the fact that Mike and Ernest Tarakji, the former principals of West Coast, quickly secured consulting agreements with Platinum Touch—the ultimate purchaser of West Coast's assets following its general assignment—also suggests that the suspiciously timed asset transfers had been crafted as a ruse to shield West Coast's assets from Callcom, while allowing its business to be continued under a new name. Again, it's *possible* this was innocent, since as appellants point out, "hiring consultants to assist with the transition of a newly purchased company seems, without more, like a sensible decision...." But of course, in this case there *was more.* Much more. And in fact, appellants' own reference to Platinum Touch as a "*newly purchased company* " is telling. Even they have a difficult time avoiding the implication that Platinum Touch was really just a renamed version of West Coast—albeit one which had shed its troubling fraud liability to Callcom. The fact the trial court was not inclined to undertake the mental gyrations necessary to avoid that conclusion is of no avail to them.

And, of course, there was no error in the court's reliance on West Coast's failure to disclose the general assignment scheme to Callcom until after it happened, as a factor supporting the determination that the transfer was intended to hinder, delay or defraud creditors. The failure of a debtor to disclose a transfer of assets to creditors is explicitly identified by statute as one of the indicia of such an intent. (Civ.Code, § 3439.04, subd. (b)(3).) Further, the fact that West Coast entered into the general assignment scheme with the explicit understanding that ABC would immediately transfer the entirety of its assets to Platinum Touch, and without first notifying West Coast's creditors as required by Civil Code section 1802, can be relied upon as the basis of inferring West Coast actually intended to deny Callcom a notice *required by law to be given* before disposition of West Coast's assets.

***7** For all of these reasons, we conclude the court did not err in determining that the transfer of West Coast's assets was accomplished with the actual intent to hinder, delay or defraud its creditors.[FN5]

FN5. Appellants' last assertion on this point, that the trial court also improperly determined the value paid for West Coast's assets was "not reasonably commensurate with their value," is equally unpersuasive. Appellants' contention rests upon the assumption that West Coast was insolvent prior to the transfer, due to the existence of the purported $4.7 million lien against its assets. But the trial court found that lien to be unsupported by evidence of any underlying debt, and as we explain, *ante,* that finding was proper.

Finally, appellants' attack on the sufficiency of the evidence to support the finding that Callcom was injured by the transfer of West Coast's assets also fails. Appellants' argument focuses on a single sentence in the court's statement of decision—which appellants claim mischaracterizes an expert's testimony regarding the value of West Coast at the time of the transfer—while failing to acknowledge the significant additional evidence, from multiple sources, suggesting that West Coast actually did have a significant positive net worth at that time.[FN6] The omission is troubling, since the court explicitly relies upon some of that additional evidence in the portion of its statement of decision where it analyzes the injury element of Callcom's cause of action. Appellants' briefing should have acknowledged that evidence.

FN6. What appellants complain about is that Callcom's expert had testified the value of West Coast, based solely on the volume of calling cards it was selling on a monthly basis, was between $4 and $5 million in 2008. However, in March of 2009, when West Coast transferred its assets to ABC, he explained that the volume of calling card sales had been significantly reduced, so that application of the same formula suggested the value of the company—based solely on its volume of calling card sales—was $800,000 to $1 million dollars at that point. The expert also noted, however, that West Coast had other assets besides its calling card sales, including ownership of an expensive software program.

In its statement of decision, the trial court at one point characterized Callcom's expert as having testified that the value of West Coast's assets was $4 million “at the date of assignment,”—making it seem as though the court may have conflated West Coast's value in 2008 with its value at the time the assets were transferred in early 2009. It is this single sentence appellants focus so much attention on. But in doing so, they ignore another part of the statement of decision, in which the court correctly notes the expert “valued [West Coast's] brands (as of March 9, 2009) at some $800,000 to $1 million,” while also noting the company also owned other assets, including proprietary accounting software.

Since it is beyond dispute that the court did not intend to rely solely on the testimony of Callcom's expert in reaching its conclusion about whether Callcom had been injured by West Coast's fraudulent transfer, and there is other evidence in the record to support that conclusion, we would be obligated to uphold it even if we believed the court had misrecollected that one piece of evidence. “Where findings of fact are challenged on a civil appeal, we are bound by the ‘elementary, but often overlooked principle of law, that ... the power of an appellate court begins and ends with a determination as to whether there is any substantial evidence, contradicted or uncontradicted,’ to support the findings below. [Citation.] We must therefore view the evidence in the light most favorable to the prevailing party, giving it the benefit of every reasonable inference and resolving all conflicts in its favor in accordance with the standard of review so long adhered to by this court. [Citations.]” (*Jessup Farms v. Baldwin* (1983) 33 Cal.3d 639, 660.)

The only other objection appellants raise about the injury element of Callcom's claim is their assertion that the court somehow overstepped its bounds by concluding the purported NetIP lien—which appellants relied upon to establish that whatever assets West Coast had were *unavailable* to satisfy any debt owed to Callcom—was not supported by credible evidence. According to appellants, the validity of that lien was “uncontroverted during the trial,” and thus the court could not find adversely to them on the point. Appellants' factual premise is simply wrong.

Callcom explicitly argued at trial—at some length—that the $4.7 million lien claimed by appellants was pure fiction. This is how Callcom's counsel summed it up to the court in closing argument: “And you've also heard from the defense a conclusory statement about the value of a supposed lien. The number $4.7 million keeps coming up.... [But] there's nothing other than the self-serving testimony and statements by the Tarakjis to support the $4.7 million number. [¶] It's important to focus on what is not in evidence here. There is no agreement between [West Coast] and Network I.P. If there was really $4.7 million owed, surely there would have been a written agreement, or at least they would have put on some invoices.... [¶] Now, obviously, the witnesses have referred to the UCC financing statement, which the witnesses have testified is for [West Coast] doing business as UT & T, United Telecom and Technologies, Inc. But the mere fact that somebody files a UCC does not create a debt. It just puts the world on notice that somebody is claiming a security interest in certain personal property. [¶] Mere notice is not enough here. They need to prove that there actually was a debt owed if they're going to rely on that.” In light of this extensive discourse, we conclude the validity of the claimed NetIP lien was thoroughly controverted at trial.

***8** Further, it makes no difference that Callcom's own witnesses “testified to the existence of the lien.” A party is certainly not bound by the testimony given by every witness it calls to the stand at trial. If that were true, no party would *ever* compel an adverse witness to testify. More important, none of the testimony cited by appellants—which came from the attorney/principal of ABC (subpoenaed by Callcom to testify about the circumstances surrounding the general assignment and subsequent sale of West Coast's assets) and from Callcom's expert witness—suggested any claim to first-hand knowledge about the validity of the lien or of the underlying debt. Stated simply, nothing in the testimony of Callcom's witnesses bound it to any concession about the validity of the purported NetIP lien.

Finally, there is no merit to appellants' suggestion the court improperly shifted the burden to them to establish the validity of the NetIP lien. According to appellants, since Callcom had the burden of proving injury—i.e., that absent the fraudulent transfer, West Coast would have had assets available to satisfy its judgment—that burden included the obligation to affirmatively establish the *non-validity* of the purported lien which negated the value of West Coast's assets. Thus, appellants believe that any lack of evidence bearing on the point—including a lack of evidence "document[ing] the existence of the underlying debt"—must result in a win for them.

We cannot agree. Callcom made a prima facie case demonstrating injury from the fraudulent transfer simply by offering evidence that, prior to the general assignment, West Coast had assets which were presumptively available to satisfy the claims of its creditors. It is the transfer of those assets beyond the creditors' reach which is the essence of the cause of action. Once Callcom made that showing, then appellants were free to offer whatever evidence they might have to demonstrate why the transferred assets were actually of no value to West Coast's creditors. That's where the evidence of a prior lien comes in. If that $4.7 million lien were valid, and secured by West Coast's assets, it would negate the first $4.7 million worth of those assets as a basis for a fraudulent transfer claim. (Civ.Code, § 3431.01, subd. (a)(1).) So if appellants had more credible, or more complete, evidence establishing the validity of the claimed NetIP lien, as they suggest in their brief they did, they should have offered that evidence at trial.

We find no error in the trial court's determination that Callcom was injured by the fraudulent transfer of West Coast's assets.

III

Appellants next assert the court's findings were insufficient to justify the imposition of consipiracy liabililty.[FN7] We find the claim unpersuasive for two reasons.

FN7. " '[T]he basis of a civil conspiracy is the formation of a group of two or more persons who have agreed to a common plan or design to commit a tortious act.' [Citations.] The conspiring defendants must also have actual knowledge that a tort is planned and concur in the tortious scheme with knowledge of its unlawful purpose. [Citations.] [¶] However, actual knowledge of the planned tort, without more, is insufficient to serve as the basis for a conspiracy claim. Knowledge of the planned tort must be combined with intent to aid in its commission." (*Kidron v. Movie Acquisition Corp.* (1995) 40 Cal.App.4th 1571, 1582.) Knowledge and intent " 'may be inferred from the nature of the acts done, the relation of the parties, the interest of the alleged conspirators, and other circumstances.' " (Ibid.) " 'The major significance of a conspiracy cause of action "lies in the fact that it renders each participant in the wrongful act responsible as a joint tortfeasor for all damages ensuing from the wrong ... regardless of the degree of his activity. [Citations.]' " ... Each member of the conspiracy becomes liable for all acts done by others pursuant to the conspiracy, and for all damages caused thereby." (*Berg & Berg Enterprises, LLC v. Sherwood Partners, Inc.* (2005) 131 Cal.App.4th 802, 823, fn. omitted.)

First, as a true challenge to the sufficiency *of the findings,* the claim is waived. It is well-settled that any deficiencies in the findings contained in a statement of decision must be brought to the attention of the trial court, or be waived. (Code Civ. Proc., § 634; *In re Marriage of Arceneaux* (1990) 51 Cal.3d 1130, 1133–1134.) Here, appellants' objection to the trial court's proposed statement of decision contained no assertion that its *findings* were insufficient to support conspiracy liability. Instead, appellants acknowledged they were challenging "the questionable inferences relied upon by the court ... [which were] also relevant to the conspiracy claim," and then challenging the sufficiency *of the evidence* to establish that either Manal Tarakji or United Telecom were participants in the conspiracy. Because appellants did not challenge the sufficiency of the court's *findings* in support of conspiracy liability below, we will not address that contention on appeal.

***9** Second, if we consider this argument as a challenge to the sufficiency of the *evidence* to support conspiracy liability against appellants generally, which is what it appears to be, we must again point out that appellants have not troubled themselves with the heavy burden imposed upon a party making such a claim. Without bothering to acknowledge the rather staggering mound of circumstantial evidence suggesting a group effort to shed West Coast's liability to Callcom, not to mention the negative inferences which are practically leaping off that mound, appellants simply focus on arguing it is *possible* to conclude their actions were innocent, and then assert that "conspiracies cannot be established by suspicions."

However, a defendant's knowledge and intent can be " ' " 'inferred from the nature of the acts done, the relation of the parties, the interest of the alleged conspirators, and other circumstances.' " ' " (*Wyatt v. Union Mortgage Co.* (1999) 24 Cal.3d 773, 785, quoting *Chicago Title Ins. Co. v. Great Western Financial Corp.* (1968) 69 Cal.2d 305, 316.) We have no difficulty concluding the circumstances were more than sufficient to support those inferences in this case. We will not belabor the point.

With respect to the conspiracy liability of Manal Tarakji and United Telecom specifically, appellants have failed to make any effort to summarize the *totality of the evidence* pertaining to those issues, or to explain why that evidence is insufficient, as a matter of law, to support the determination that either participated in the conspiracy. "A party who challenges the sufficiency of the evidence to support a particular finding must summarize the evidence on that point, *favorable and unfavorable, and show how and why it is insufficient.*" (*Roemer v. Pappas* (1988) 203 Cal.App.3d 201, 208, italics added.) Consequently, the claim of insufficiency of the evidence pertaining to those appellants specifically is waived.

But in any event, we have no trouble locating evidence sufficient to support the inference that both Manal Tarakji and United Telecom were participants in the conspiracy. Manal was a 25 percent owner of West Coast, which was valued at between $4 million and $5 million in 2008, and yet she signed a written consent to the general assignment scheme in March of 2009, by which West Coast would transfer its assets to ABC for $1, after which ABC would immediately transfer those assets to a third party—Platinum Touch—to continue running the business as a going concern. This occurred only three months after Manal's brother, Stephan, sold *his* 25 percent interest in West Coast for the agreed price of $235,000. No owner of such an apparently valuable business would agree to essentially give it away unless (a) she believed doing so was the only effective way to avoid the business' significant liability to a third party—in other words, that Manal did so in this case as a participant in the alleged conspiracy; or (b) she had been persuaded that the company had *suddenly* lost *its entire value* for other reasons. Appellants point to no evidence of the latter.

***10** As for United Telecom, the evidence suggested it conspired in the attempt to utilize *its own* debtor-creditor relationship with NetIP, as the basis for attempting to create a secured lien against *West Coast's* assets, by filing a UCC statement claiming the debtor was "West Coast Distribution, Inc., dba United TeleCom and Technologies." That purported lien was then relied upon for the assertion that West Coast had no assets available to pay Callcom's judgment. That inference was sufficient to support United Telecom's inclusion in the conspiracy.

In light of the foregoing, we find no error in either the court's findings in favor of conspiracy liability, or its inclusion of Manal Tarakji and United Telecom among the conspirators.

IV

Appellants' final contention is that the court erred by arbitrarily rejecting the testimony of those witnesses whose testimony favored appellants' preferred interpretation of what occurred in this case. Appellants claim that "[u]nless impeached or contradicted by other testimony or by an inference deducible from the facts proved, or unless it is inherently improbable, the court must accept [testimony] as true."

However, to state the argument is to demonstrate why it is of no assistance to appellants here. Stated simply, appellants' version of events was *thoroughly* impeached and contradicted *by inferences deducible from the facts proved.* Indeed, the sequence of events here fairly shouted fraudulent conveyance. And while we could not say that appellants' version of the facts was incredible as a matter of law, we can say that the obvious inferences to be drawn from the proven facts in this case weighed strongly against them. Under these circumstances, the court certainly did not err by concluding their version of events was not credible.

DISPOSITION

The judgment is affirmed. Callcom is to recover its costs on appeal.

WE CONCUR: O'LEARY and FYBEL, JJ.

Cal.App. 4 Dist.,2011.
El Saad v. Tarakji
Not Reported in Cal.Rptr.3d, 2011 WL 5910059 (Cal.App. 4 Dist.)

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    - 10 MB file size maximum;
    - PDF must be unlocked and not password protected.
4. Upload your completed and signed PDF form and submit electronically through eForms Online.

Your submission will be reviewed for legal compliance and you will receive an email with an approval or a notice to correct your submission.

If you prefer submitting this form via mail or in person, fill out the Submission Cover Sheet and attach it to your filing. Note: In person submissions require an additional $15 handling fee.

Secretary of State
Business Programs Division
Business Entities, 1500 11th Street, Sacramento, CA 95814

California Stock Corporation
Dissolution Requirements – What Form to File

What form(s) do I file to dissolve my California Stock Corporation?

Form to Use	Requirements
Short Form Dissolution Certificate - Form DSF STK	**All** of the following statements about the California corporation must be true: a) Was registered in California **within the last 12 months**; b) Has no debts or other liabilities, except as provided in Item c; c) The tax liability will be satisfied on a taxes paid basis or the tax liability will be assumed; d) All required California final tax returns have been or will be filed with the California Franchise Tax Board; e) No business has been conducted from the date of registration; f) No shares have been issued, and if the corporation has received payments for shares from investors, those payments have been returned to those investors; g) The corporation is dissolved; and h) The assets have been distributed or the corporation acquired no known assets. Note: If filing Form DSF STK, Form ELEC STK and Form DISS STK **are not required**. (California Corporations Code section 1900.5.)
Certificate of Election to Wind Up and Dissolve – Form ELEC STK	• If the California stock corporation cannot answer yes to all of the items a) – h) above; **and** • If the vote to dissolve was made by **less than all** the shareholders. Note: If the vote to dissolve was made by **all** of the shareholders and that fact is stated on Form DISS STK, Form ELEC STK **is not required**. (California Corporations Code section 1901.)
Certificate of Dissolution – Form DISS STK	• If the California stock corporation cannot answer yes to all of the items a) – h) above. Note: If the vote to dissolve was made by **less than all** of the shareholders, Form ELEC STK must be filed prior to or together with Form DISS STK. (California Corporations Code section 1905.)

The status of the corporation **must be active** on the records of the California Secretary of State in order to file dissolution documents. The status of the corporation can be checked online on the Secretary of State's Business Search at BusinessSearch.sos.ca.gov.

Instructions for Completing the Certificate of Election to Wind Up and Dissolve (Form ELEC STK)

(California Stock Corporation ONLY)

To put all on notice that the corporation has elected to wind up and dissolve, a California stock corporation must complete the Certificate of Election to Wind Up and Dissolve (Form ELEC STK). Before submitting the completed form, you should consult with a private attorney for advice about your specific business needs.

- Form ELEC STK has been created for ease in filing, however, any format may be used, provided it meets statutory requirements.
- The status of the corporation **must be active** in order to file dissolution documents. The status of the corporation can be checked online on the Secretary of State's Business Search at BusinessSearch.sos.ca.gov.

Important Additional Steps to Terminate the Corporation:

1. **Completing the Dissolution Process:** To complete the dissolution process, the corporation also **must file a** Certificate of Dissolution - Stock (Form DISS STK). This Form ELEC STK is not required when the vote to dissolve was made by **all** of the shareholders and that fact is stated on the Form DISS STK.
2. **Final Tax Returns:** See California Franchise Tax Board's (FTB) Publication 1038 – Guide to Dissolve, Surrender, or Cancel a California [or Foreign] Business Entity – https://www.ftb.ca.gov/forms/misc/1038.html.
   - All final returns required under the California Revenue and Taxation Code must be filed timely (Form 100/100S) with the FTB and the $800 minimum franchise tax for the tax year of the final return must be paid. If final returns are not filed, the corporation will remain FTB active and continue to be subject to the $800 minimum franchise tax for each taxable year.
   - For information regarding FTB forms and publications go to ftb.ca.gov or contact the FTB at (800) 852-5711 (from within the U.S.) or (916) 845-6500 (from outside the U.S.).

Fees:

- **Filing Fee:** There is **no fee** for filing this Certificate of Election to Wind Up and Dissolve (Form ELEC STK).
- **Faster Service Fee:**
  - **Counter Drop Off:** A separate, non-refundable **$15.00** counter drop off fee is required if you deliver in person (drop off) your completed document at our Sacramento office. The $15.00 counter drop off fee provides priority service over documents submitted by mail. The special handling fee is not refundable whether the document is filed or rejected.
  - **Guaranteed Expedite Drop Off:** For more urgent submissions, documents can be processed within a guaranteed timeframe for a non-refundable fee in lieu of the counter drop off fee. For detailed information about this faster processing service through our Preclearance and Expedited Filing Services, go to www.sos.ca.gov/business/be/service-options.
  - Counter and guaranteed expedite services are available only for documents *delivered in person (drop off) to our Sacramento office*.

Copies: To get a copy of the filed document, include payment for copy fees when the document is submitted. Copy fees are $1.00 for the first page and $.50 for each attachment page. For certified copies, there is an additional $5.00 certification fee, per document.

Payment Type: Check(s) or money orders should be made payable to the Secretary of State. **Do not send cash by mail.** If submitting the document in person in our Sacramento office, payment also may be made by credit card (Visa or Mastercard®).

Processing Dates: For current processing dates, go to www.sos.ca.gov/business/be/processing-dates.

If you are not completing this form online, please **type or legibly print** in black or blue ink. **Complete the Certificate of Election to Wind Up and Dissolve (Form ELEC STK) as follows:**

Item	Instruction	Tips
1.	Enter the name of the Corporation **exactly** as it appears on file with the California Secretary of State, including the entity ending (ex: "Jones & Company, Inc." or "Smith Construction Company").	• If the corporation is a *California nonprofit corporation*, do not file this Form ELEC STK; file a Certificate of Election to Wind Up and Dissolve – Nonprofit (Form ELEC NP). • If the corporation is a *registered foreign corporation* (formed outside of California), do not file this Form ELEC STK; file the Certificate of Surrender (Form SURR-CORP) to terminate registration in California.
2.	Enter the 7-digit corporate Entity Number issued to the corporation by the California Secretary of State at the time of registration.	• The 7-digit Entity (File) Number is provided by the Secretary of State on the corporation's registration document filed with the California Secretary of State. • To ensure you have the correct Entity Number and exact name of the corporation, look to your registration document filed with the California Secretary of State and any name change amendments. • Secretary of State Records can be accessed online through our Business Search at BusinessSearch.sos.ca.gov. While searching the Business Search, be sure to identify your corporation correctly, including the jurisdiction that matches your corporation.
3.	You must check the appropriate box (**check one**).	• This Form ELEC STK **is not required** if the vote to dissolve the corporation was made by **ALL** of the shareholders, and that fact is stated on the Certificate of Dissolution (Form DISS STK). • If first box is checked, enter the **number** of shares that voted in favor of the dissolution. **Do not** enter the percentage of shares that voted in favor of the dissolution. • The Certificate of Election to Wind Up and Dissolve puts all on notice that the corporation has elected to wind up the business of the corporation and is in the process of paying liabilities and distributing assets. • In order to terminate the corporation, the corporation also **must file a** Certificate of Dissolution (Form DISS STK).
4.	This statement is required by statute and must not be altered.	
5.	You must check the appropriate box (**check one**).	

6.	• *If the first box of Item 5 was checked*, Form ELEC STK must be dated, signed and verified by the sole director or a majority of the directors now in office; • *If the second box of Item 5 was checked*, Form ELEC STK must be dated, signed and verified by the chairperson of the board, president or vice president **and** the secretary, chief financial officer, treasurer, assistant secretary or assistant treasurer. (Section 173); or • *If the third box of Item 5 was checked*, Form ELEC STK must be dated, signed and verified by Shareholder(s) authorized to sign this certificate by shareholders holding shares representing at least 50 percent of the voting power of the above-named corporation.	• Verification requires a statement under penalty of perjury under the laws of the State of California that the matters set forth in the certificate are true and correct of the signor's own knowledge. (Section 193.) • To complete the verification, the date must be the date the document is signed by **each** person. • If you need more space for additional signatures: - The dated signature(s) **with verification** must be placed on only one side of a standard letter-sized piece of paper (8 1/2" x 11") clearly marked as an attachment to the Certificate of Election to Wind Up and Dissolve (Form ELEC STK) and attach the extra page(s) to the completed Certificate of Election to Wind Up and Dissolve (Form ELEC STK). - The following verification must be included with additional signatures and date(s) on an attachment: I declare under penalty of perjury under the laws of the State of California that the matters set forth in the certificate are true and correct of my own knowledge. - All attachments are part of this document. • Multiple Certificates of Election to Wind Up and Dissolve (Form ELEC STK) with **different signatures** will be returned without being filed.

Return Receipt Requested: It is recommended for proof of submittal that if the Certificate of Election to Wind Up and Dissolve is mailed to the Secretary of State, it be sent by Certified Mail with Return Receipt Requested.

Legal Authority: General statutory filing provisions are found in California Corporations Code section 1901. All statutory references are to the California Corporations Code.

ELEC STK

Secretary of State

Certificate of Election to Wind Up and Dissolve

(California Stock Corporation ONLY)

IMPORTANT — Read Instructions before completing this form.

There is N**o Fee** for filing a Certificate of Election to Wind Up and Dissolve - Stock

Copy Fees – First page $1.00; each attachment page $0.50;
Certification Fee - $5.00 plus copy fees

This Space For Office Use Only

1. Corporate Name (Enter the exact name of the corporation as it is recorded with the California Secretary of State.)

2. 7-Digit Secretary of State Entity Number

3. Election (Check the applicable statement. Only **one box** may be checked. If the first box is checked, enter the **number** of shares (**do not** enter the percentage of shares). Note: This Form ELEC STK is not required when the vote to dissolve was made by all of the shareholders and that fact is noted on the Certificate of Dissolution (Form DISS STK).)

☐ The election was made by the vote of ______________________ shares of the corporation, and representing at least 50 percent of the voting power.

☐ The corporation has not issued any shares; the election was made by the board of directors of the corporation.

4. Required Statement (This Statement is required. Do not alter.)

The corporation has elected to wind up and dissolve.

5. Signatory Authority (Check the applicable statement. Only **one box** may be checked.)

The undersigned is/are the:

☐ Sole director or a majority of the directors now in office of the above-named corporation.

☐ Chairperson of the board, president or vice president and the secretary, chief financial officer, treasurer, assistant secretary or assistant treasurer of the above-named corporation.

☐ Shareholder(s) authorized to sign this certificate by shareholders holding shares representing at least 50 percent of the voting power of the above-named corporation.

6. Read, Verify, Date and Sign Below (**See Instructions for signature requirements**.)

I declare under penalty of perjury under the laws of the State of California that the matters set forth in this certificate are true and correct of my own knowledge.

Date	Signature	Type or Print Name
Date	Signature	Type or Print Name
Date	Signature	Type or Print Name

Instructions for Completing the Certificate of Dissolution (Form DISS STK)

(California Stock Corporation ONLY)

To terminate (dissolve) a California stock corporation, complete the Certificate of Dissolution (Form DISS STK). Before submitting the completed form, you should consult with a private attorney for advice about your specific business needs.

- Form DISS STK has been created for ease in filing, however, any format may be used, provided it meets statutory requirements.
- Upon filing Form DISS STK, the corporation will be terminated and the corporation's powers, rights and privileges will cease in California.
- The status of the corporation **must be active** on the records of the California Secretary of State in order to file dissolution documents. The status of the corporation can be checked online on the Secretary of State's Business Search at BusinessSearch.sos.ca.gov.

Fees:

- **Filing Fee:** There is **no fee** for filing this Certificate of Dissolution (Form DISS STK).
- **Faster Service Fee:**
  - **Counter Drop Off:** A separate, non-refundable **$15.00** counter drop off fee is required if you deliver in person (drop off) your completed document at our Sacramento office. The $15.00 counter drop off fee provides priority service over documents submitted by mail. The special handling fee is not refundable whether the document is filed or rejected.
  - **Guaranteed Expedite Drop Off:** For more urgent submissions, documents can be processed within a guaranteed timeframe for a non-refundable fee in lieu of the counter drop off fee. For detailed information about this faster processing service through our Preclearance and Expedited Filing Services, go to www.sos.ca.gov/business/be/service-options.
  - Counter and guaranteed expedite services are available only for documents *delivered in person (drop off) to our Sacramento office*.

Copies: To get a copy of the filed document, include payment for copy fees when the document is submitted. Copy fees are $1.00 for the first page and $.50 for each attachment page. For certified copies, there is an additional $5.00 certification fee, per document.

Payment Type: Check(s) or money orders should be made payable to the Secretary of State. **Do not send cash by mail.** If submitting the document in person in our Sacramento office, payment also may be made by credit card (Visa or Mastercard®).

Processing Dates: For current processing dates, go to www.sos.ca.gov/business/be/processing-dates.

If you are not completing this form online, please **type or legibly print** in black or blue ink. **Complete the Certificate of Dissolution (Form DISS STK) as follows:**

Item	Instruction	Tips
1.	Enter the name of the Corporation **exactly** as it appears on file with the California Secretary of State, including the entity ending (ex: "Jones & Company, Inc." or "Smith Construction Company").	• If the corporation is a *California nonprofit corporation*, do not file this Form DISS STK; file a Certificate of Dissolution – Nonprofit (Form DISS NP). • If the corporation is a *registered foreign corporation* (formed outside of California), do not file this Form DISS STK; file a Certificate of Surrender (Form SURR-CORP) to terminate the registration in California.

2.	Enter the 7-digit corporate Entity Number issued to the corporation by the California Secretary of State at the time of registration.	• The 7-digit corporate Entity (File) Number is provided by the Secretary of State on the corporation's registration document filed with the California Secretary of State. • To ensure you have the correct Entity Number and exact name of the corporation, look to your registration document filed with the California Secretary of State and any name change amendments. • Secretary of State Records can be accessed online through our Business Search at BusinessSearch.sos.ca.gov. While searching the Business Search, be sure to identify your corporation correctly including the jurisdiction that matches your corporation.
3.	Check the box **only** if the vote to dissolve was made by the vote of **all** the shareholders.	• If the dissolution was made by the vote of **all** the shareholders of the California corporation, check the box. The Certificate of Election - Stock (Form ELEC STK) is not required. • If the box is not checked, a **Certificate of Election of Election to Wind Up and Dissolve** (Form ELEC STK) must be filed prior to or together with this Certificate of Dissolution (Form DISS STK).
4.	• Must check the box next to the applicable statement. Only one box may be checked. • If the second box is checked, specify in an **attachment** to this certificate the name and address of the assumer **and** the provisions made for the assumed or guaranteed payment.	• If the second box is checked, you must include in an attachment the name, address and descriptions of the provisions made with the assumer, guarantor or depositary institution. • The assumer or guarantor must be the corporation, person or governmental agency. • See filing tips for Item 6 below for details on using an attachment.
5.	These statements are required by statute and must not be altered.	See Final Tax Returns section below.
6.	• This Certificate of Dissolution (Form DISS STK) must be dated, signed and verified by a majority of the directors in office or by the sole director, if there is only one.	• Verification requires a statement under penalty of perjury under the laws of the State of California that the matters set forth in the certificate are true and correct of the signor's own knowledge. (Section 193.) • To complete the verification, the date must be the date the document is signed by **each** person. • If you need more space for additional signatures: - The dated signature(s) **with verification** must be placed on only one side of a standard letter-sized piece of paper (8 1/2" x 11") clearly marked as an attachment to the Certificate of Dissolution (Form DISS STK) and attach the extra page(s) to the completed Certificate of Dissolution (Form DISS STK). - The following verification must be included with additional signatures and date(s) on an attachment: I declare under penalty of perjury under the laws of the State of California that the matters set forth in the certificate are true and correct of my own knowledge. - All attachments are part of this document. • Multiple Certificates of Dissolution (Form DISS STK) with **different signatures** will be returned without being filed.

Return Receipt Request: It is recommended for proof of submittal that if the Certificates of Dissolution (Form DISS STK) is mailed to the California Secretary of State, it be sent by Certified Mail with Return Receipt Requested.

Legal Authority: General statutory filing provisions are found in California Corporations Code section 1905. All statutory references are to the California Corporations Code.

Final Tax Returns: See California Franchise Tax Board's (FTB) Publication 1038 – Guide to Dissolve, Surrender, or Cancel a California [or Foreign] Business Entity – https://www.ftb.ca.gov/forms/misc/1038.html.

- All final returns required under the California Revenue and Taxation Code must be filed timely (Form 100/100S) with the FTB and the $800 minimum franchise tax for the tax year of the final return must be paid. If final returns are not filed, the corporation will remain FTB active and continue to be subject to the $800 minimum franchise tax for each taxable year.
- For information regarding FTB forms and publications go to ftb.ca.gov or contact the FTB at (800) 852-5711 (from within the U.S.) or (916) 845-6500 (from outside the U.S.).

Secretary of State
Certificate of Dissolution
(California Stock Corporation ONLY)

DISS STK

IMPORTANT — Read Instructions before completing this form.

There is N**o Fee** for filing a Certificate of Dissolution - Stock

Copy Fees – First page $1.00; each attachment page $0.50;

Certification Fee - $5.00 plus copy fees

This Space For Office Use Only

1. Corporate Name (Enter the exact name of the Corporation as it is recorded with the California Secretary of State.)	**2. 7-Digit Secretary of State Entity Number**

3. Election

☐ The dissolution was made by a vote of **ALL** of the shareholders of the California corporation.

Note: If the above box is not checked, a **Certificate of Election to Wind Up and Dissolve** (Form ELEC STK) must be filed prior to or together with this Certificate of Dissolution. (California Corporations Code section 1901.)

4. Debts and Liabilities (Check the applicable statement. Only **one box** may be checked. If second box is checked, must include the required information in an attachment.)

☐ The known debts and liabilities have been actually paid or paid as far as its assets permitted.

☐ The known debts and liabilities have been adequately provided for in full or as far as its assets permitted by their assumption. Included in the **attachment** to this certificate, incorporated herein by this reference, is a description of the provisions made and the name and address of the person, corporation or government agency that has assumed or guaranteed the payment, or the depository institution with which deposit has been made.

☐ The corporation never incurred any known debts or liabilities.

5. Required Statements (Do not alter the Required Statements – **ALL** must be true to file Form DISS STK.)

a. The Corporation has been completely wound up and is dissolved.
b. All final returns required under the California Revenue and Taxation Code have been or will be filed with the California Franchise Tax Board.
c. The known assets have been distributed to the persons entitled thereto or the corporation acquired no known assets.

6. Read, Verify, Date and Sign Below (**See Instructions for signature requirements.**)

The undersigned is the sole director or a majority of the directors now in office. I declare under penalty of perjury under the laws of the State of California that the matters set forth in this certificate are true and correct of my own knowledge.

Date	Signature	Type or Print Name
Date	Signature	Type or Print Name
Date	Signature	Type or Print Name

Associated Vendors, Inc. v. Oakland Meat Co.

Court of Appeal of California, First Appellate District, Division One

December 17, 1962

Civ. No. 20302

Reporter

210 Cal. App. 2d 825 *; 26 Cal. Rptr. 806 **; 1962 Cal. App. LEXIS 1639 ***

ASSOCIATED VENDORS, INC., Plaintiff and Appellant, v. OAKLAND MEAT CO., INC. et al., Defendants and Respondents

Subsequent History: [*1]** Appellant's Petition for a Hearing by the Supreme Court was Denied February 13, 1963.

Prior History: APPEAL from a judgment of the Superior Court of Alameda County. Monroe Friedman, Judge.

Action to recover unpaid rental on leased property.

Disposition: Affirmed. Judgment for defendants affirmed.

Core Terms

Meat, lease, trial court, stock, retail, bills, ownership, entities, corporate entity, percent, capitalization, premises, funds, negotiations, fixtures, factors, rent, corporate veil, disregarded, checks, rental, cases, unity, inequitable result, personal liability, undercapitalization, equitable, records

Case Summary

Procedural Posture

Appellant lessor brought an action to recover unpaid rents from respondent corporation, alleging it was the alter-ego of respondent lessee. The Superior Court of Alameda County (California) entered judgment in favor of the lessor against the lessee, and in favor of the corporation. The lessor appealed the judgment in favor of the corporation.

Overview

Upon the lessee's default of rent and vacation of the premises, the lessor relet the premises to a sublessee on the lessee's behalf, at a monthly rental which was less than what the lessee was obligated to pay under the lease. The lessor sought to impose liability for the difference upon a corporation on the theory that the corporation was the alter ego of the lessees. The lessor argued that there was uncontroverted evidence that disclosed factors which required that the corporate entity be disregarded, and that the two elements of unity of ownership and inequity were so conclusively present as to compel the disregard of the corporate entity. The court disagreed and held that there was ample evidence to support the inferences drawn by the lower court that there was not such a unity of interest and ownership as between the lessee and the corporation as to destroy the individuality of the corporations and the stock owners. The court held that evidence of inadequate capitalization was merely a factor to be considered by the lower court in deciding whether or not to pierce the corporate veil, but there was evidence that supported the finding of adequate capitalization.

Outcome
The judgment in favor of the corporation was affirmed.

LexisNexis® Headnotes

Civil Procedure > ... > Standards of Review > Substantial Evidence > General Overview

HN1[] **Standards of Review, Substantial Evidence**

On appeal all conflicts in the evidence must be resolved in favor of the respondent, and that all legitimate and reasonable inferences will be indulged in to uphold the findings of the trial court. It is an elementary principle of law that the power of an appellate court begins and ends with a determination as to whether there is any substantial evidence, contradicted or uncontradicted, which will support the conclusion reached by a trial judge.

Business & Corporate Law > ... > Piercing the Corporate Veil > Alter Ego > General Overview

Business & Corporate Law > ... > Shareholder Duties & Liabilities > Piercing the Corporate Veil > General Overview

HN2[] **Piercing the Corporate Veil, Alter Ego**

The conditions under which a corporate entity may be disregarded, or the corporation be regarded as the alter ego of the stockholders, necessarily vary according to the circumstances in each case inasmuch as the doctrine is essentially an equitable one and for that reason is particularly within the province of the trial court. Only general rules may be laid down for guidance. The two requirements are (1) that there be such unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist, and (2) that, if the acts are treated as those of the corporation alone, an inequitable result will follow. With respect to the second requirement, it is sufficient that it appear that recognition of the acts as those of a corporation only will produce inequitable results.

Business & Corporate Law > ... > Shareholder Duties & Liabilities > Piercing the Corporate Veil > General Overview

HN3[] **Shareholder Duties & Liabilities, Piercing the Corporate Veil**

Before a corporation's acts and obligations can be legally recognized as those of a particular person, and vice versa, it must be made to appear that the corporation is not only influenced and governed by that person, but that there is such a unity of interest and ownership that the individuality, or separateness, of such person and corporation has ceased, and that the facts are such that an adherence to the fiction of the separate existence of the corporation would, under the particular circumstances, sanction a fraud or promote injustice.

Business & Corporate Law > ... > Shareholder Duties & Liabilities > Piercing the Corporate Veil > General Overview

Civil Procedure > ... > Standards of Review > Substantial Evidence > General Overview

HN4[] **Shareholder Duties & Liabilities, Piercing the Corporate Veil**

A determination of whether or not to pierce the corporate veil is primarily one for a trial court and is not a question of law; and the conclusion of the trier of fact will not be disturbed if it be supported by substantial evidence.

Business & Corporate Law > ... > Shareholder Duties & Liabilities > Piercing the Corporate Veil > General Overview

Business & Corporate Law > ... > Corporate Finance > Initial Capitalization & Stock Subscriptions > General Overview

Business & Corporate Law > Corporations > Corporate Governance > General Overview

Business & Corporate Law > ... > Corporate

Governance > Record Inspection & Maintenance > General Overview

HN5[] **Shareholder Duties & Liabilities, Piercing the Corporate Veil**

A variety of factors are pertinent to the trial court's determination of whether or not to pierce the corporate veil under the particular circumstances of each case. Among these are the following: commingling of funds and other assets, failure to segregate funds of the separate entities, and the unauthorized diversion of corporate funds or assets to other than corporate uses; the treatment by an individual of the assets of the corporation as his own; the failure to obtain authority to issue stock or to subscribe to or issue the same; the holding out by an individual that he is personally liable for the debts of the corporation; the failure to maintain minutes or adequate corporate records, and the confusion of the records of the separate entities; the identical equitable ownership in the two entities; the identification of the equitable owners thereof with the domination and control of the two entities; identification of the directors and officers of the two entities in the responsible supervision and management; sole ownership of all of the stock in a corporation by one individual or the members of a family; the use of the same office or business location; the employment of the same employees and/or attorney; the failure to adequately capitalize a corporation; and the total absence of corporate assets and undercapitalization.

Business & Corporate Law > ... > Piercing the Corporate Veil > Alter Ego > Corporate Formalities

Business & Corporate Law > ... > Shareholder Duties & Liabilities > Piercing the Corporate Veil > General Overview

Business & Corporate Law > ... > Shareholder Duties & Liabilities > Piercing the Corporate Veil > Sham Corporations

Business & Corporate Law > ... > Shareholders > Shareholder Duties & Liabilities > Personal Liability

HN6[] **Alter Ego, Corporate Formalities**

Factors pertinent to the trial court's determination of whether or not to pierce the corporate veil may include: the use of a corporation as a mere shell, instrumentality or conduit for a single venture or the business of an individual or another corporation; the concealment and misrepresentation of the identity of the responsible ownership, management and financial interest, or concealment of personal business activities; the disregard of legal formalities and the failure to maintain arm's length relationships among related entities; the use of the corporate entity to procure labor, services or merchandise for another person or entity; the diversion of assets from a corporation by or to a stockholder or other person or entity, to the detriment of creditors, or the manipulation of assets and liabilities between entities so as to concentrate the assets in one and the liabilities in another; the contracting with another with intent to avoid performance by use of a corporate entity as a shield against personal liability, or the use of a corporation as a subterfuge of illegal transactions; and the formation and use of a corporation to transfer to it the existing liability of another person or entity.

Business & Corporate Law > ... > Piercing the Corporate Veil > Alter Ego > Inadequate Capitalization

Business & Corporate Law > ... > Shareholder Duties & Liabilities > Piercing the Corporate Veil > General Overview

HN7[] **Alter Ego, Inadequate Capitalization**

Evidence of inadequate capitalization is, at best, merely a factor to be considered by a trial court in deciding whether or not to pierce the corporate veil.

Headnotes/Summary

Headnotes
CALIFORNIA OFFICIAL REPORTS HEADNOTES

CA(1a)[] **(1a)** *CA(1b)*[] **(1b)** *CA(1c)*[] **(1c)**

Corporations—Disregard of Corporate Entity—Evidence.

--There was substantial evidence in the record to support the trial court's findings that one corporation was not the *alter ego* of another corporation and the directors, officers, and the owners of its stock, where, among other things, the two corporations were incorporated separately and at different times; each corporation employed separate counsel; the corporation whose entity was sought to be disregarded issued stock pursuant to a permit and in compliance with the formalities required by the Division of Corporations; each corporation kept separate minutes, maintained separate records and bank accounts, had its own employees and a separate payroll, made disbursements through its own checks, and did not commingle its funds with the other corporation's; and one corporation supplied from 30 to 45 per cent of the merchandise sold by the other corporation, the remaining merchandise coming from other suppliers.

CA(2)[] **(2)**

Appeal—Questions of Law and Fact—Power of Court.

--The appellate court's power begins and ends with a determination as to whether there is any substantial evidence, contradicted or uncontradicted, which will support the conclusion reached by the trial judge.

CA(3)[] **(3)**

Id.—Questions of Law and Fact—Consideration of Evidence.

--On appeal, undisputed testimony may not be considered to the utter disregard of disputed testimony that favors respondent.

CA(4)[] **(4)**

Corporations—Disregard of Corporate Entity—Province of Trial Court.

--The conditions under which a corporate entity may be disregarded, or a corporation be regarded as the *alter ego* of the stockholders, vary according to the circumstances in each case since the doctrine is essentially an equitable one and for that reason is particularly within the province of the trial court. Only general rules may be laid down for guidance.

CA(5)[] **(5)**

Id.—Disregard of Corporate Entity.

--To justify the disregard of a corporate entity there must be such unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist, and an inequitable result will follow if the corporate acts are treated as those of the corporation alone.

CA(6)[] **(6)**

Id.—Disregard of Corporate Entity—Alter Ego of Individuals.

--Before a corporation's acts and obligations can be legally recognized as those of a particular person, and vice versa, it must be made to appear that the corporation is not only influenced and governed by that person, but that there is such a unity of interest and ownership and the individuality or separateness of such person and corporation has ceased, and that the facts are such that an adherence to the fiction of the separate existence of the corporation would, under the particular circumstances, sanction a fraud or promote injustice.

CA(7)[] **(7)**

Id.—Disregard of Corporate Entity—When Power Will Be Exercised.

--Though the rule governing the disregard of a corporate entity does not depend on the presence of actual fraud, it is designed to prevent what would be fraud or injustice, if accomplished; accordingly, bad faith in one form or another is an underlying consideration and will be found in some form or another in those cases where the trial court was justified in disregarding the corporate entity.

CA(8)[] **(8)**

Id.—Disregard of Corporate Entity—Inadequate Capitalization.

--Evidence of inadequate capitalization is merely a factor to be considered by the trial court in deciding whether to pierce the corporate veil. But this factor alone does not require that the corporate entity in question be disregarded.

CA(9)[] **(9)**

Id.—Disregard of Corporate Entity—Evidence.

--Testimony to the effect that a corporation's operating capital was adequate, that it paid all of its bills for two years except for the money owed to the corporation alleged to be its *alter ego*, that bills were paid promptly, that rent was paid until its premises were vacated, and testimony by the president of the corporation alleged to be the *alter ego* that assurances had been made to him that the capitalization would be adequate was evidence, if believed by the trial court, that would support its finding of adequate capitalization.

CA(10)[] **(10)**

Id.—Disregard of Corporate Entity—Evidence.

--To justify the disregard of a corporate entity, it is not sufficient merely to show that a creditor will remain unsatisfied if the corporate veil is not pierced.

CA(11)[] **(11)**

Id.—Disregard of Corporate Entity—When Power Will Be Exercised.

--The purpose of the doctrine of disregarding a corporate entity is not to protect every unsatisfied creditor, but rather to afford him protection where some conduct amounting to bad faith makes it inequitable, under established rules, for the corporation's equitable owner to hide behind its corporate veil.

Counsel: Robert C. Burnstein and Sandra J. Shapiro for Plaintiff and Appellant.

Connella, Sherburne & Myers and E. Conrad Connella for Defendants and Respondents.

Judges: Molinari, J. Bray, P. J., and Sullivan, J., concurred.

Opinion by: MOLINARI

Opinion

[*827] [807]** Appellant, Associated Vendors, Inc., brought this action against respondents Oakland Meat Co., Inc., (hereinafter referred to as Meat Co.) Oakland Meat & Packing Co., (hereinafter referred to as Packing Co.), and several individuals, to collect unpaid rental on property leased by appellant to respondent Packing Co., and to recover the difference between the rental provided in the lease with Packing Co. and the rental now being paid by a new tenant. Appellant alleged that, upon Packing Co.'s default in payment of rent and vacation of the premises, appellant relet the premises to one Frank H. Black, on Packing Co.'s behalf, at a monthly **[***2]** rental which was less than the rental Packing Co. was obligated to pay under the terms of the lease. Appellant sought to impose liability upon the Meat Co. and the individuals on the theory that Packing Co., the lessee under the lease, was the *alter ego* of the other respondents. Appellant also sought attorney's fees and an injunction against respondents restraining them from selling or otherwise transferring certain obligations incurred by Frank H. Black.

Following a trial on the merits, the court found in favor of appellant as against Packing Co., and in favor of the other defendants to the action. Appellant appeals from the judgment.

[*828] The sole issue on appeal is whether the trial court erred in holding that Packing Co. was not the *alter ego* of respondents.

Statement of Facts

The appellant, as lessor, leases market space in the Housewives Market in Oakland. In November 1956, one of the appellant's tenants, Clarence Klieman, went into bankruptcy. The appellant thereupon entered into the negotiations hereinafter set forth for a lease of the premises formerly occupied by Klieman. At the time of said negotiations Meat Co. was an established meat wholesaler. **[***3]** The directors and officers of Meat Co. were Zaharis, Lafayette, White and Frueh. Zaharis was its president and the owner of 26 per cent of its stock. He had been an officer, director and shareholder since it was formed. Lafayette owned 26 per cent of the stock, while White and Frueh owned 24 per cent each. The preliminary negotiations for said lease were held at a meeting in November of 1956.

Allan Schulman, president of the appellant corporation, testified concerning said meeting as follows: that he, in his then capacity as secretary-treasurer of appellant, and Phil Davidson, one of its directors, met with respondents, Zaharis and Lafayette, at the office of Meat Co. to discuss the possible lease to Meat Co. of the meat department premises formerly occupied by Klieman; that Zaharis and Lafayette stated to him that "they" wanted to lease said department in order to recoup certain losses which they had sustained in sales of meat to Klieman; that he (Schulman) stated the rent would be $ 3,000 for the first month, and $ 1,500 every month thereafter, for a term of eight years; that he further stated that $ 4,500 was to be paid in advance, $ 1,500 thereof being lease security; and **[***4]** that no mention **[**808]** was made of the name of the person who would appear as lessee on the lease. Davidson's testimony regarding this meeting was substantially the same as Schulman's. He testified that at said meeting there was no mention of a lease to anyone other than Meat Co., and that he was of the opinion, then, that Associated Vendors was dealing with Meat Co.

Zaharis testified as follows with reference to the said meeting: That it was held on November 20, 1956, in Davidson's office, and not at that of the Meat Co.; that present, besides himself, were Davidson, Klieman, and Arthur Weikert. (Weikert was General Manager of the market.) That there never was any meeting between Schulman, Davidson, Lafayette **[*829]** and himself; that at said meeting he (Zaharis) stated that he was interested in purchasing the fixtures which were being foreclosed, running the retail business, and signing a lease, providing the officers of Meat Co., who were meeting the next day, were interested; that he "was not interested in personal liability" and that he asked Weikert and Davidson if he "could use the name Housewives Meat Company for the new business as a new corporation"; that they **[***5]** said "no, it was too similar to the Housewives Market," and that then he (Zaharis) stated: "'If you are interested in me signing a lease it will have to be a separate corporation.'" Zaharis testified further as to the terms of the proposed lease. (These were the same as those specified above by Schulman.) Lafayette denied being present at any such meeting.

Klieman testified that such a meeting was held, and that present were the same persons mentioned by Zaharis. Klieman testified further that at this meeting Zaharis stated that "he would have to have a new corporation because he wanted no personal liability on himself" or the Meat Co. Weikert denied being present at the meeting and stated that he did not meet Zaharis until 1959.

The evidence discloses that contemporaneously with these negotiations Zaharis had been in contact with a Mr. Stanley Whitney concerning the acquisition of a corporation known as Town & Country Farms, which was organized for the purpose of developing real estate, had not issued any stock and had never commenced doing any business. Whitney was the attorney for said corporation and pursuant to negotiations with Zaharis undertook to amend the articles and **[***6]** certificate of said corporation by changing its name to Oakland Meat & Packing Company (referred to herein as Packing Co.).

Zaharis testified, further, that the day after the aforesaid meeting, Weikert phoned him for "his answer"; that he told Weikert he "personally was interested in it" and that he "told them that if they wanted me to form a new corporation, sign the lease, that I wanted no personal liability, I would be glad to do it"; that Weikert said he would discuss it with the officials of appellant, and that if they agreed that they would make a lease and bring it to him; that a "day or two after the market was opened" he received another telephone call from Weikert wherein Weikert stated that "the officials of the corporation at the Housewives Market was interested in getting the lease signed because we were operating without **[*830]** a lease"; that he replied that he "couldn't sign the lease until the corporation papers were back from Sacramento"; that a similar conversation was had one or two days later; and that the day following the last conversation the papers were obtained. Zaharis also testified that "we were operating for two or three days before there was a lease **[***7]** signed."

Copies of the lease in question had, in the meantime, been prepared by Robert C. Burnstein, attorney for appellant, who forwarded them to Whitney with a letter of transmittal specifically requesting that the lease be signed by an authorized officer of Packing Co. and that the seal of said corporation be impressed upon it. Whitney had continued to act as attorney for Packing Co., and upon the change of name becoming effective, proceeded to make application for a permit to issue stock under the **[**809]** new name. Both copies of the lease were subsequently signed in Whitney's office by Zaharis and White as president and secretary-treasurer, respectively, of Packing Co. and its seal was affixed thereto. Whitney then brought both copies of the lease, together with Packing Co.'s check for $ 4,500 representing the first month's rent and the security deposit, to the appellant's premises where they were signed by two officers of the appellant. The said lease designates the appellant as lessor and Packing Co. as lessee, and bears an execution date of December 3, 1956.

Whitney testified that he never represented Meat Co. and did not know of its existence until the time he was **[***8]** engaged to effect the said change of name. After the lease was signed, Whitney negotiated on behalf of Packing Co. for the purchase of certain fixtures from a certain Al Weikert (brother of the Weikert hereinbefore referred to). A conditional sales contract was entered into between said Al Weikert, as seller, and Packing Co., as purchaser. This contract was signed by Zaharis and White in their capacities as officers of Packing Co. Whitney testified that when he delivered the contract to Al Weikert it bore these signatures and Packing Co.'s seal. The terms of said contract provided for a down payment of $ 1,032.89, and a time balance of $ 14,787.08.

Pursuant to a permit for the issuance of stock, Zaharis became the sole shareholder of Packing Co. by the acquisition of 80 shares of its stock for which he paid $ 8,000. A certificate for said stock to Zaharis was issued on April 24, 1957. The officers and directors of Packing Co. were Zaharis, White and Frueh. Zaharis was elected its president. According **[*831]** to the testimony of both Zaharis and Lafayette the latter was not in any way affiliated with Packing Co.

Schulman testified, further, that at the time said lease **[***9]** was being negotiated he was familiar with Meat Co.; that it had a good reputation and credit; and that he had not heard that a new company was being organized. He testified that he first heard of Packing Co. in November of 1958, and that prior to that time he did not know that there was a difference between Meat Co. and Packing Co., and that although he knew the lease was in Packing Co.'s name he did not know that this identified an organization separate from Meat Co. He also testified that he never saw a Packing Co. sign on the market premises.

Zaharis' total investment in Packing Co. was the $ 8,000 which he paid for the corporate stock. He withdrew $ 6,000 to $ 7,000 from Meat Co. These were personal funds and not company funds. Of the said sum of $ 8,000, the sum of $ 4,500 was used to pay the first month's rent and the lease deposit to appellant, the sum of $ 1,032.89 was used as a down payment on the fixtures, and the sum of $ 700 was paid as the first installment under the fixture conditional sale contract. When Packing Co. began business operations it had about $ 1,500 in cash. It had acquired on credit an opening inventory valued at between $ 2,000 and 3,000. The **[***10]** monthly rental was $ 1,500, the installment payment on the fixtures $ 700, and the weekly payroll was $ 893.67. The equipment in the shop belonged to the Trustee in Bankruptcy who permitted Packing Co. to use it pending the bankruptcy sale. The fixtures which were purchased for approximately $ 16,000 were valued by Zaharis at $ 60,000 in place, less than $ 50,000 if not installed. They were subsequently sold for $ 9,000.

About three months after the commencement of business Packing Co. was in need of funds. The sum of $ 3,500 was required to purchase the equipment from the trustee. Zaharis loaned $ 5,000 to the Packing Co. There are no minutes and no vote evidencing the transaction. A year later Zaharis needed the $ 5,000 for another venture. Packing Co. did not have the money to repay the loan, so a loan of $ 5,000 was made by Meat Co. to Packing Co. in order to repay Zaharis. This was the only loan ever made by Meat Co. to Packing Co. A chattel mortgage upon Packing Co.'s equity in the fixtures was executed on May 26, 1958, but was not recorded until December 17, 1958. **[**810]** This loan has not been repaid, nor has **[*832]** Meat Co. made a demand for its payment. **[***11]** Zaharis did not make any other loans to Packing Co., nor did he pay any of its bills.

During Packing Co.'s business operations, Meat Co. advanced credit to Packing Co. Meat Co., however, was only one of several suppliers who continued to supply on credit. Packing Co.'s purchases amounted to approximately $ 25,000 per month. From 60 per cent to 70 per cent of such merchandise was procured from suppliers other than Meat Co. No price advantage was given or received by Meat Co. When Packing Co. vacated the leased premises it still owed Meat Co. about $ 15,000. This debt has not been paid nor have any arrangements been made for repayment. Zaharis testified: that this bill was not paid because the other creditors were paid in preference to Meat Co.; that he had guaranteed all other companies that there was no connection between the two companies; that he did not want to be responsible for owing any creditor any money; that he wanted to take the loss if any should arise; and that he wanted to protect his reputation. Lafayette testified: that Meat Co. did not intend to sue Packing Co. for this indebtedness because Packing Co. has no assets; that a suit would be worthless; and that **[***12]** the obligation would be merely written off. Packing Co. has paid all of its other obligations, bills and all of the rent up to the time it ceased doing business in January 1959.

Zaharis, White and Frueh rendered services to Packing Co. without compensation. They did, however, continue to receive their regular compensation from Meat Co. Zaharis testified that he devoted all of his time to Meat Co., and that his participation in the management of Packing Co. consisted of telephoning the manager of the market two or three times a day. Lafayette acted gratuitously as a business advisor and on occasion examined Packing Co.'s books. Lafayette testified, however, that he did not do any work on Packing Co.'s books, nor did he sign any of its checks. On occasion Lafayette would pick up the cash from the retail market.

Other than its retail activities in the Housewives Market, Packing Co. did not maintain an office. Its books were kept at the Meat Co.'s address, and its bookkeeper worked on Packing Co.'s books at the Meat Co.'s office. Most of Packing Co.'s mail was addressed to the retail premises, but on occasion some of it was addressed to the Meat Co.'s office. **[*833]** On one **[***13]** occasion a letter was addressed to Meat Co., "attention Mr. Lafayette," concerning an employee of Packing Co. There was testimony that certain bills were addressed to Meat Co. for items properly concerning Packing Co. The Packing Co. had a separate telephone at the retail outlet but did not have a phone at the Meat Co. office. Mail arriving at the Meat Co.'s office would be opened by the same person, a Miss Duarte, whether addressed to Meat Co. or to Packing Co. Miss Duarte acted as bookkeeper for Packing Co. part of the time and for Meat Co. the rest of the time. There was testimony concerning the approval of bills received through the mail at Meat Co.'s office. Because some of the officers acted in an official capacity for both companies the persons who would approve paying the bills were often the same regardless of which company paid the bill. Packing Co.'s bills were mailed from Meat Co.'s office, and all of said company's bills were paid from that office by said bookkeeper. All payments and all disbursements of Packing Co., including rent to appellant, were made upon its own checks and from its own bank accounts.

The licenses and permits permitting Packing Co. to operate **[***14]** a retail meat business bore the name "Oakland Meat Company." These licenses and permits were posted in a conspicuous place by the manager. City license notices were sent to "Oakland Meat Company, Housewives Market." The fees, however, were paid for by Packing Co. Zaharis testified that he had not seen the licenses and permits, and that the name "Oakland Meat" was put thereon without **[**811]** his permission. He also stated that this name was an abbreviation of Packing Co.'s name. The union contract covering Packing Co.'s retail employees only showed the name "Oakland Meat" as employer and was signed by Crowell, the manager of the retail department. Zaharis testified he had never seen a copy of this contract and that it should have shown Packing Co.'s name as the employer. A union representative testified that retail butcher complaints and wage claims were taken up with Lafayette. Separate workmen's compensation and fire policies were carried by Packing Co. in its own name, but the public liability and property damage insurance coverage for Packing Co. was added to Meat Co.'s policy. The insurance broker testified that this was done at the suggestion of the insurance company **[***15]** because the identity of the individuals exposed to liability, with the exception of Lafayette, **[*834]** was the same; that it was more expedient to have the coverage with one company, and also that there would be a saving in premiums. On occasion Meat Co.'s automobiles were used by Packing Co. Zaharis stated that this was done as a favor.

Zaharis also testified as to his credit, stating he could get several thousand dollars worth of meat on the signature of an employee in the market. He stated further that the sum of $ 1,000 to $ 1,500 together with the cash intake of $ 25,000 per month was adequate to operate the market for a month. It was his testimony that the market had brought in about $ 25,000 per month prior to Packing Co. taking over, and that while Packing Co. was operating the retail market it brought in from $ 6,000 to $ 7,000 per week. Several wholesalers' representatives testified that credit was extended to Packing Co. because they relied on Zaharis' personal credit and integrity and upon the standing of Meat Co. in the meat industry.

A Mr. Pitcher testified that he sold and serviced equipment at the retail premises from time to time; that he billed Meat Co.; **[***16]** and was never informed that the bill was directed to the wrong company. He testified further that he was told by a butcher at the retail market to deliver the merchandise there, but to send the bill to the Meat Co. Pitcher stated that he didn't know there was any difference between Meat Co. and Packing Co., and that he didn't realize that they were two different companies. He stated further that he did work for both the Meat Co. and Packing Co. and testified that certain invoices for merchandise delivered to and work done at the retail market were paid for by Packing Co. checks.

Other testimony was adduced from several persons who dealt with Packing Co. showing that some confused the names of the two corporations. A Mr. Pariani testified that he charged meat delivered to the retail store to Packing Co. but invoiced it to "Oakland Meat." Pariani, however, testified that he knew of the existence of the two companies; that he dealt with both of them; and that each had a separate account number. Mr. Egland, a representative of Swift & Company, stated that meat delivered to Packing Co. was billed to "Oakland Meat Company," but he also testified Swift sold meat to both companies; that **[***17]** he was aware of the existence of the two companies at the different addresses, and the different nature of the two companies. A Joseph Thelen testified that the records of his company (Lewis & **[*835]** McDermott, Inc.) listed the name of "Oakland Meat Co." rather than Oakland Meat & Packing Co., but that it was a result of laxity or brevity, stating: "We knew it wasn't the same company." Thelen testified further that his company dealt with both corporations; that he knew they were separate corporations; and that separate ledger sheets were kept for each. A Mr. Vignaux of Victor Meat Corporation dealt with both companies and maintained separate accounts, listing each company by its proper name. There was also testimony to the effect that when a Pierce Packing Company billed Meat Co. for Packing Co.'s meat, Meat Co. (through Mr. Frueh) objected to this procedure to Guidoni, the **[**812]** manager of the retail outlet. The record contains further evidence, mostly repetitious, which gives conflicting impressions on the unity or separateness of the two corporations. There was also evidence of billings properly made, and testimony that, irrespective of the manner of billing, the **[***18]** disbursements for Packing Co.'s bills were on Packing Co's checks.

There was also evidence presented that Packing Co. and Meat Co. kept separate bank accounts, separate sets of accounts, made separate disbursements, using checks bearing the individual company name; maintained separate payrolls; that the companies used different fiscal years for tax purposes; that they were represented by different counsel; and that they maintained separate minutes.

The Trial Court's Findings

CA(1a)[] **(1a)** There is substantial evidence contained in the record to uphold the findings of the trial court under the time honored rule that *HN1*[] on appeal all conflicts in the evidence must be resolved in favor of the respondent, and that all legitimate and reasonable inferences will be indulged in to uphold the findings of the trial court. *CA(2)*[] **(2)** It is an elementary principle of law that the power of the appellate court begins and ends with a determination as to whether there is any substantial evidence, contradicted or uncontradicted, which will support the conclusion reached by the trial judge. *(Thayer v. Pacific Elec. Ry. Co., 55 Cal.2d 430, 438 [11 Cal.Rptr. 560, 360 P.2d 56]*; *Crawford v. Southern Pacific* ***[***19]*** *Co., 3 Cal.2d 427, 429 [45 P.2d 183]*; *Wade v. Campbell, 200 Cal.App.2d 54, 63 [19 Cal.Rptr. 173]*.) The appellant, in its briefs, acknowledges that any conflicts in the evidence must be resolved in favor of respondents and therefore states that it **[*836]** sets forth only the undisputed testimony in its statement of facts because it feels that this undisputed testimony alone is sufficient to compel reversal of the judgment below. *CA(3)*[] **(3)** What the appellant overlooks is that this "undisputed testimony" may not be considered to the utter disregard of disputed testimony which favors respondents. The appellant's statement of facts presents a case upon which a trial court *might* decide to pierce the corporate veil, but looking to all of the facts, which we have narrated above, it is another matter to say that under these facts the corporate veil must be pierced.

CA(1b)[] **(1b)** The essence of the trial court's findings is that Packing Co. is a separate and distinct entity from Meat Co.; that it was not organized by any of the respondents; that it has never been the *alter ego* of any of the respondents or used by them to operate any of their businesses under other than their own names; **[***20]** that there was no confusion between the two corporations and their affairs were conducted separately; that there was no commingling of Packing Co.'s funds with those of Meat Co. or the individual respondents; and that Packing Co. was adequately capitalized in relation to the reasonable requirements of its business and corporate purposes.

The appellant does not attack any specific finding of the trial court but contends not only that the uncontroverted evidence discloses factors which *require* that the corporate entity be disregarded, but that the two elements of unity of ownership and inequity are so *conclusively present* as to compel the disregard of such entity. The appellant further asserts that Packing Co.

was under-capitalized as a matter of law and that this factor is sufficient in itself to warrant a disregard of the corporate entity. In attempting to sustain its position the appellant relies, generally, upon appellate decisions which have upheld judgments disregarding the corporate entity where the factual situation presented supplied factors which *allowed* the trial court to arrive at that conclusion.

Did the Trial Court Err in Refusing to Disregard the Corporate **[***21]** *Entity*

CA(4)[] **(4)** It is a fundamental rule that ***HN2***[] "[the] conditions under which the corporate entity may be disregarded, or the **[**813]** corporation be regarded as the *alter ego* of the stockholders, **[*837]** necessarily vary according to the circumstances in each case inasmuch as the doctrine is essentially an equitable one and for that reason is particularly within the province of the trial court. Only general rules may be laid down for guidance." *(Stark v. Coker, 20 Cal.2d 839, 846 [129 P.2d 390]*; *H.A.S. Loan Service, Inc. v. McColgan, 21 Cal.2d 518, 523 [133 P.2d 391, 145 A.L.R. 349]*; *Automotriz etc. De California v. Resnick, 47 Cal.2d 792, 796 [306 P.2d 1]*.) ***CA(5)***[] **(5)** The basic rule stated by our Supreme Court as a guide in the application of this doctrine is as follows: The two requirements are (1) that there be such unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist, and (2) that, if the acts are treated as those of the corporation alone, an inequitable result will follow. *(Automotriz etc. De California v. Resnick, supra, 47 Cal.2d 792, 796*; *Stark v. Coker, supra, 20 Cal.2d **[***22]** 839, 846*; *Watson v. Commonwealth Ins. Co., 8 Cal.2d 61, 68 [63 P.2d 295]*; *Minifie v. Rowley, 187 Cal. 481, 487 [202 P. 673]*.) With respect to the second requirement, it is sufficient that it appear that recognition of the acts as those of a corporation only will produce inequitable results. *(Stark v. Coker, supra, p. 846*; *Watson v. Commonwealth Ins. Co., supra, p. 68*.) ***CA(6)***[] **(6)** The general rule is thus stated as follows: ***HN3***[] "'Before a corporation's acts and obligations can be legally recognized as those of a particular person, and vice versa, it must be made to appear that the corporation is not only influenced and governed by that person, but that there is such a unity of interest and ownership that the individuality, or separateness, of such person and corporation has ceased, and that the facts are such that an adherence to the fiction of the separate existence of the corporation would, under the particular circumstances, sanction a fraud or promote injustice.'" *(Talbot v. Fresno-Pacific **[**814]** Corp., 181 Cal.App.2d 425, 431 [5 Cal.Rptr. 361]*; *Temple v. Bodega Bay Fisheries, Inc., 180 Cal.App.2d 279, 283 [4 Cal.Rptr. 300]*.)

[*23]** The gist of the cases which have considered the doctrine is that *both* of these requirements must be found to exist before the corporate existence will be disregarded; ***HN4***[] that such determination is primarily one for the trial court and is not a question of law; and that the conclusion of the trier of fact will not be disturbed if it be supported by substantial evidence. (See also *H.A.S. Loan Service, Inc. v. McColgan, supra, 21 Cal.2d 518, 524*; *Kasutoff v. Wahlstrom, 196 Cal.App.2d 65, 69 **[*838]** [16 Cal.Rptr. 207]*; *Talbot v. Fresno-Pacific Corp., supra, 181 Cal.App.2d 425, 432*; *Carlesimo v. Schwebel, 87 Cal.App.2d 482, 492 [197 P.2d 167]*.) ***CA(7)***[] **(7)** It should also be noted that, while the doctrine does not depend on the presence of actual fraud, it is designed to prevent what would be fraud or injustice, if accomplished. Accordingly, bad faith in one form or another is an underlying consideration and will be found in some form or another in those cases wherein the trial court was justified in disregarding the corporate entity. (See *Talbot v. Fresno-Pacific Corp., supra, 181 Cal.App.2d 425, 431*; *Hollywood Cleaning & Pressing Co. v. Hollywood **[***24]** Laundry Service, Inc., 217 Cal. 124, 129 [17 P.2d 709]*; *Carlesimo v. Schwebel, supra, 87 Cal.App.2d 482, 491*; *Erkenbrecher v. Grant, 187 Cal. 7 [200 P. 641]*.)

A review of the cases which have discussed the problem discloses the consideration of ***HN5***[] a variety of factors which were pertinent to the trial court's determination under the particular circumstances of each case. Among these are the following: Commingling of funds and other assets, failure to segregate funds of the separate entities, and the unauthorized diversion of corporate funds or assets to other than corporate uses (*Riddle v. Leuschner, 51 Cal.2d 574 [335 P.2d 107]*; *Talbot v. Fresno-Pacific Corp., supra, p. 431*; *Thomson v. L. C. Roney & Co., 112 Cal.App.2d 420 [246 P.2d 1017]*; *Asamen v. Thompson, 55 Cal.App.2d 661 **[**815]** [131 P.2d 841]*; *Goldberg v. Engelberg, 34 Cal.App.2d 10 [92 P.2d 935]*; *Sweet v. Watson's Nursery, 33 Cal.App.2d 699 [92 P.2d 812]*); the treatment by an individual of the assets of the corporation as his own (*Minton v. Cavaney, 56 Cal.2d 576 [15 Cal.Rptr. 641, 364 P.2d 473]*; *Thompson v. L. C. Roney & Co., **[***25]** supra*; *Riddle v. Leuschner, supra*); the failure to obtain authority to issue stock or to subscribe to or issue the same (*Automotriz etc. De California v. Resnick, supra, 47 Cal.2d 792*; *Wheeler v. Superior Mortgage Co., 196 Cal.App.2d 822 [17*

Cal.Rptr. 291]; Marr v. Postal Union Life Ins. Co., 40 Cal.App.2d 673 [105 P.2d 649]; Claremont Press Pub. Co. v. Barksdale, 187 Cal.App.2d 813 [10 Cal.Rptr. 214]; Engineering etc. Corp. v. Longridge Inv Co., 153 Cal.App.2d 404 [314 P.2d 563]; Shafford v. Otto Sales Co., Inc., 149 Cal.App.2d 428 [308 P.2d 428]); the holding out by an individual that he is personally liable for the debts of the corporation (Stark v. Coker, supra, 20 Cal.2d 839; Shafford v. Otto Sales Co., Inc., supra); the failure to maintain minutes or adequate corporate records, and the confusion of the records of the separate entities **[*839]** (Riddle v. Leuschner, supra, 51 Cal.2d 574; Stark v. Coker, supra; Temple v. Bodega Bay Fisheries, Inc., supra, 180 Cal.App.2d 279; Shafford v. Otto Sales Co., Inc., supra); the identical equitable ownership in the two **[***26]** entities; the identification of the equitable owners thereof with the domination and control of the two entities; identification of the directors and officers of the two entities in the responsible supervision and management; sole ownership of all of the stock in a corporation by one individual or the members of a family (Riddle v. Leuschner, supra; Stark v. Coker, supra; McCombs v. Rudman, 197 Cal.App.2d 46 [17 Cal.Rptr. 351]; Talbot v. Fresno-Pacific Corp., supra, 181 Cal.App.2d 425; Claremont Press Pub. Co. v. Barksdale, supra, 187 Cal.App.2d 813; Thomson v. L. C. Roney Co., supra, 112 Cal.App.2d 420; Asamen v. Thompson, supra, 55 Cal.App.2d 661; Sweet v. Watson's Nursery, supra, 33 Cal.App.2d 699; Goldberg v. Engleberg, supra, 34 Cal.App.2d 10; Gordon v. Aztec Brewing Co., 33 Cal.2d 514 [203 P.2d 522]; Pan Pacific Sash & Door Co. v. Greendale Park, Inc., 166 Cal.App.2d 652 [333 P.2d 802]; Shea v. Leonis, 14 Cal.2d 666 [96 P.2d 332]); the use of the same office or business location; the employment of the same employees and/or attorney (McCombs v. Rudman, supra; Talbot **[***27]** v. Fresno-Pacific Corp., supra; Thomson v. L. C. Roney Co., supra; Pan Pacific Sash & Door Co. v. Greendale Park, Inc., supra); the failure to adequately capitalize a corporation; the total absence of corporate assets and undercapitalization (Minton v. Cavaney, supra, 56 Cal.2d 576; Automotriz etc. De California v. Resnick, supra, 47 Cal.2d 792; Stark v. Coker, supra, 20 Cal.2d 839; Talbot v. Fresno-Pacific Corp., supra, 181 Cal.App.2d 425; Temple v. Bodega Bay Fisheries, Inc., supra, 180 Cal.App.2d 279; Wheeler v. Superior Mortgage Co., supra, 196 Cal.App.2d 822; Claremont Press Pub. Co. v. Barksdale, supra, 187 Cal.App.2d 813; Engineering etc. Corp. v. Longridge Inv. Co., supra, 153 Cal.App.2d 404; Shafford v. Otto Sales Co., Inc., supra, 149 Cal.App.2d 428; Shea v. Leonis, supra, 14 Cal.2d 666; Pan Pacific Sash & Door Co. v. Greendale Park, Inc., supra, 166 Cal.App.2d 652); **HN6**[] the use of a corporation as a mere shell, instrumentality or conduit for a single venture or the business of an individual or another corporation (McCombs v. Rudman, supra, 197 Cal.App.2d 46; **[***28]** Asamen v. Thompson, supra, 55 Cal.App.2d 661; Engineering etc. Corp. v. Longridge Inv. Co., supra; Pan Pacific Sash & Door Co. v. Greendale Park, Inc., supra); the concealment and **[*840]** misrepresentation of the identity of the responsible ownership, management and financial interest, or concealment of personal business activities (Riddle v. Leuschner, supra, 51 Cal.2d 574; Shafford v. Otto Sales Co., Inc., supra); the disregard of legal formalities and the failure to maintain arm's length relationships among related entities (Riddle v. Leuschner, supra, 51 Cal.2d 574; McCombs v. Rudman, supra; Wheeler v. Superior Mortgage Co., supra; Pan Pacific Sash & Door Co. v. Greendale Park, Inc., supra); the use of the corporate entity to procure labor, services or merchandise for another person or entity (Temple v. Bodega Bay Fisheries, Inc., supra; Pan Pacific Sash & Door Co. v. Greendale Park, Inc., supra; Engineering etc. Corp. v. Longridge Inv. Co., supra); the diversion of assets from a corporation by or to a stockholder or other person or entity, to the detriment of creditors, or the manipulation **[***29]** of assets and liabilities between entities so as to concentrate the assets in one and the liabilities in another (Riddle v. Leuschner, supra, 51 Cal.2d 574; Thomson v. L. C. Roney Co., supra, 112 Cal.App.2d 420; Sweet v. Watson's Nursery, supra, 33 Cal.App.2d 699; Talbot v. Fresno-Pacific Corp., supra, 181 Cal.App.2d 425); the contracting with another with intent to avoid performance by use of a corporate entity as a shield against personal liability, or the use of a corporation as a subterfuge of illegal transactions (Wheeler v. Superior Mortgage Co., supra, 196 Cal.App.2d 822; Claremont Press Pub. Co. v. Barksdale, supra, 187 Cal.App.2d 813; Shafford v. Otto Sales Co., Inc., supra, 149 Cal.App.2d 428; Asamen v. Thompson, supra, 55 Cal.App.2d 661); and the formation and use of a corporation to transfer to it the existing liability of another person or entity (Shea v. Leonis, supra, 14 Cal.2d 666; Engineering etc. Corp. v. Longridge Inv. Co., supra, 153 Cal.App.2d 404). A perusal of these cases reveals that in all instances several of the factors mentioned were present. It is particularly significant that **[***30]** while it was held, in each instance, that the trial court was warranted in disregarding the corporate entity, the factors considered by it were not deemed to be conclusive upon the trier of fact but were found to be supported by substantial evidence.

In the instant case the presence or absence of any of these factors, as well as the consideration of any other circumstances which would have warranted the trier of fact to disregard the corporate entity, were within the province of the trial court. *CA(1c)*[] **(1c)** There was ample evidence to support the inferences drawn by the lower court that there was not such a **[*841]** unity of interest and ownership as between Packing Co. and Meat Co., or as between Packing Co. and the individual respondents, as to destroy the individuality of such corporations and the owner or owners of their stock. We need not repeat the evidence in detail, but a reiteration of the following facts supports the sufficiency of the trial court's findings, to wit: Zaharis' ownership of 26 per cent of Meat Co.'s stock and his ownership of 100 per cent of Packing Co.'s stock; the ownership by Lafayette of 26 per cent of Meat Co.'s stock and the fact that he was not a director **[***31]** or officer of Packing Co.; the ownership by White and Frueh of 24 per cent of Meat Co.'s stock each and their nonownership of Packing Co.'s stock; the separate incorporation of two corporations at different times; the employment of separate counsel by each corporation and the fact that the attorney for Packing Co. was not the attorney for any of the respondents; the issuance of stock by Packing Co. pursuant to permit and its compliance with the formalities required by the Division of Corporations; the keeping of separate minutes by Packing Co. and its holding of a **[**816]** number of meetings; the maintenance of separate records and bank accounts by Packing Co.; the fact that Packing Co. had its own employees and a separate payroll; the extent of the participation of Zaharis and the other individual respondents in the daily business affairs of Packing Co.; the making of disbursements by Packing Co. through its own checks; the absence of the commingling of funds; the fact that Meat Co. supplied Packing Co. from 30 per cent to 45 per cent of the meat sold by the latter, the remainder coming from other suppliers; the preparation of the lease by appellant's own attorney and the naming **[***32]** of Packing Co. as the lessee therein; and Zaharis' statement that he did not want any personal liability and that he would form a new corporation. Any conflict in the evidence with respect to any of these matters was, of course, for the trier of fact to resolve.

Considerable stress is laid by the appellant upon the claim of undercapitalization and its assertion that such appears in the instant case as a matter of law. Appellant has not cited any case in which an appellate court has held that a business was undercapitalized when the court made a contrary finding. In almost every instance where the trial court has found inadequate capitalization there are other factors present. (See cases above cited with reference to capitalization.) In some cases there were no assets or capitalization at all. *CA(8)*[] **(8)** *HN7*[] Evidence of inadequate capitalization is, at best, merely a factor to be **[*842]** considered by the trial court in deciding whether or not to pierce the corporate veil. To be sure, it is an important factor, but no case has been cited, nor have any been found, where it has been held that this factor alone *requires* invoking the equitable doctrine prayed for in the instant case. In **[***33]** *Carlesimo v. Schwebel, supra, 87 Cal.App.2d 482*, a total capitalization of $ 1,221.82 was held not to be insufficient, as a matter of law, to operate a business engaged in the buying and selling of groceries. *CA(9)*[] **(9)** Furthermore, we have testimony in the instant case, to the effect that the operating capital was adequate; that Packing Co. paid all of its bills for two years except for the money owed to Meat Co.; that the bills were paid promptly; and that the rent was paid until Packing Co. vacated the premises. There is also testimony by Zaharis that appellant's officer, Davidson, assured him that the capitalization would be adequate. This evidence, if believed by the trial court, would support its finding of adequate capitalization.

The appellant's assertion of inequitable result is predicated upon the argument that the respondents intentionally created a corporation without sufficient assets to meet daily business requirements. The thrust of this argument is the claim of undercapitalization and the contention that a creditor will remain unsatisfied if the corporate veil is not pierced. As we have pointed out above, the prerequisite of "inequitable result" must coexist with **[***34]** the other requirement of unity of interest and ownership, which the trial court has found not to exist in this case. Moreover, we have also indicated that the trial court was justified in its finding of adequate capitalization. *CA(10)*[] **(10)** Certainly, it is not sufficient to merely show that a creditor will remain unsatisfied if the corporate veil is not pierced, and thus set up such an unhappy circumstance as proof of an "inequitable result." In almost every instance where a plaintiff has attempted to invoke the doctrine he is an unsatisfied creditor. *CA(11)*[] **(11)** The purpose of the doctrine is not to protect every unsatisfied creditor, but rather to afford him protection, where some conduct amounting to bad faith makes it inequitable, under the applicable rule above cited, for the equitable owner of a corporation to hide behind its corporate veil.

The judgment is affirmed.

347 Group, Inc. v. Philip Hawkins Architect, Inc.

Court of Appeal of California, Third Appellate District

December 7, 2020, Opinion Filed

C091273

Reporter
58 Cal. App. 5th 209 *; 2020 Cal. App. LEXIS 1156 **; 2020 WL 7136870

347 GROUP, INC., Plaintiff and Respondent, v. PHILIP HAWKINS ARCHITECT, INC., Defendant and Appellant.

Prior History: [1]** APPEAL from a judgment of the Superior Court of Placer County, No. SCV0034521, Richard J. Couzens, Judge.

Disposition: Reversed with directions.

Core Terms

attorney's fees, alter ego, cause of action, entitled to an attorney, ego, breach of contract, prevailed, prevailing party, trial court, parties

Case Summary

Overview

HOLDINGS: [1]-Because plaintiff's alter ego action was on the contract and the signatory defendant plaintiff obtained a breach of contract default judgment against—the party the nonsignatory defendant was alleged to be the alter ego of—was liable for attorney fees under the contract, the nonsignatory defendant was entitled to attorney fees under the principles of mutuality that informed *Civ. Code, § 1717*.

Outcome

Order reversed and matter remanded with directions.

LexisNexis® Headnotes

Business & Corporate Compliance > ... > Breach > Contracts Law > Breach

Civil Procedure > Appeals > Standards of Review > De Novo Review

Civil Procedure > Appeals > Standards of Review > Questions of Fact & Law

Civil Procedure > ... > Attorney Fees & Expenses > Basis of Recovery > Statutory Awards

HN1[] **Contracts, Breach**

"On a contract" as used in *Civ. Code, § 1717*, does not mean only traditional breach of contract causes of action. Rather, California courts liberally construe "on a contract" to extend to any action as long as an action involves a contract and one of the parties would be entitled to recover attorney fees under the contract if that party prevails in its lawsuit. An appellate court reviews whether a party is entitled to attorney fees under *Civ. Code, § 1717*, de novo, as it is a question of law.

Civil Procedure > ... > Attorney Fees & Expenses > Basis of Recovery > Statutory Awards

HN2[] Basis of Recovery, Statutory Awards

The intent of *Civ. Code, § 1717*, is to ensure mutuality in the availability of attorney fees, and its purposes require *§ 1717* be interpreted to further provide a reciprocal remedy for a nonsignatory defendant, sued on a contract as if the nonsignatory defendant were a party to it, when a plaintiff would clearly be entitled to attorney fees should the plaintiff prevail in enforcing the contractual obligation against the defendant.

Business & Corporate Compliance > ... > Contracts Law > Breach > Breach of Contract Actions

Civil Procedure > Judgments > Relief From Judgments > Altering & Amending Judgments

Contracts Law > Third Parties

Civil Procedure > Judgments > Entry of Judgments > Nonparties Affected by Judgment

HN3[] Breach, Breach of Contract Actions

A procedural vehicle available to a party asserting alter ego liability is to sue the alter ego directly in an action for breach of contract. Another procedural vehicle is to first obtain a judgment for breach of contract against the signatories to the contract, followed by a motion to amend the judgment to add the alter egos as defendants. *Code Civ. Proc., § 187*. Still another is, after obtaining a judgment against the signatories, to institute an independent action against the alter egos. These different procedural vehicles, however, are identical in substance: in all three, the proof of alter ego is the same.

Business & Corporate Compliance > ... > Contract Conditions & Provisions > Contracts Law > Contract Conditions & Provisions

Civil Procedure > Remedies > Costs & Attorney Fees

Contracts Law > Third Parties

HN4[] Contracts, Contract Conditions & Provisions

Generally, when a judgment is rendered in a case involving a contract that includes an attorney fees and costs provision, the judgment extinguishes all further contractual rights, including the contractual attorney fees clause. That rule is true in general, but not as to an alter ego claim. The reason an alter ego can be added to a judgment is because, in the eyes of the law, the alter ego was a party, albeit by a different name. For a prevailing alleged alter ego, it is as though the alleged alter ego was a party to the original lawsuit, and prevailed. Consequently, a postjudgment action to establish alter ego liability for a judgment on a contract is itself an action on the contract regardless of which procedural vehicle the plaintiff employs.

Business & Corporate Compliance > ... > Contract Conditions & Provisions > Contracts Law > Contract Conditions & Provisions

Civil Procedure > ... > Attorney Fees & Expenses > Basis of Recovery > Statutory Awards

HN5[] Contracts, Contract Conditions & Provisions

When a plaintiff files a complaint containing causes of action within the scope of *Civ. Code, § 1717* (that is, causes of action sounding in contract and based on a contract containing an attorney fee provision), and the plaintiff thereafter voluntarily dismisses the action, *§ 1717* bars the defendant from recovering attorney fees incurred in defending those causes of action, even though the contract on its own terms authorizes recovery of those fees.

Civil Procedure > ... > Attorney Fees & Expenses > Basis of Recovery > Statutory Awards

HN6[] Basis of Recovery, Statutory Awards

Civ. Code, § 1717, subd. (b), does not bar recovery of attorney fees on any particular cause of action when that cause of action is voluntarily dismissed. The section instead bars a prevailing party determination when an action is dismissed. *§ 1717, subd. (b)*. The "action" described in *§ 1717, subd. (b)*, is the action on the contract — the very thing entitling a party to attorney fees under that section. *§ 1717, subd. (a)*.

Headnotes/Summary

Summary

[*209] CALIFORNIA OFFICIAL REPORTS SUMMARY

After obtaining a default judgment against the signatory defendant for breach of contract, plaintiff dismissed its breach of contract claim against the two nonsignatory defendants, the alleged alter egos of the signatory defendant. The nonsignatory defendants prevailed on the remaining fraudulent conveyance and conspiracy claims against them and filed a motion for attorney fees, which the trial court denied. (Superior Court of Placer County, No. SCV0034521, Richard J. Couzens, Judge.)

The Court of Appeal reversed the order and remanded the matter. The court found that if plaintiff had prevailed in its action to deem the individual nonsignatory defendant an alter ego of the signatory defendant, the individual nonsignatory defendant would have been liable for any attorney fee award that was a component of the contract signed by the signatory defendant. Under the principles of mutuality that inform *Civ. Code, § 1717*, the individual nonsignatory defendant was entitled to fees as the prevailing party. *Section 1717, subd. (b)*, does not bar recovery of attorney fees on any particular cause of action when that cause of action is voluntarily dismissed. The section instead bars a prevailing party determination when an action is dismissed (*§ 1717, subd. (b)*). The "action" described in *§ 1717, subd. (b)*, is the action on the contract—the very thing entitling a party to attorney fees under that section. (Opinion by Robie, J., with Hull, Acting P. J., and Murray, J., concurring.)

Headnotes

CALIFORNIA OFFICIAL REPORTS HEADNOTES

CA(1)[] **(1)**

Costs § 25—Attorney Fees—Contract Provisions.

"On a contract" as used in *Civ. Code, § 1717, subd. (a)*, does not mean only traditional breach of contract causes of action. Rather, California courts liberally construe "on a contract" to extend to any action as long as an action involves a contract and one of the parties would be entitled to recover attorney fees under the contract if that party prevails in its lawsuit.

CA(2)[] **(2)**

Costs § 35—Attorney Fees—Appellate Review—Standard.

The appellate court reviews whether a party is entitled to attorney fees under *Civ. Code, § 1717*, de novo, as it is a question of law.

CA(3)[] **(3)**

Costs § 25—Attorney Fees—Contract Provisions—Mutuality—Nonsignatory Defendant.

The intent of *Civ. Code, § 1717*, is to ensure mutuality in the availability of attorney fees, and its purposes require *§ 1717* be interpreted to further provide a reciprocal remedy for a nonsignatory defendant, sued on a contract as if the nonsignatory defendant were a party to it, when a plaintiff would clearly be entitled to attorney fees should the plaintiff prevail in enforcing the contractual obligation against the defendant.

CA(4)[] **(4)**

Contracts § 45—Breach—Alter Ego Liability—Procedural Vehicles.

A procedural vehicle available to a party asserting alter ego liability is to sue the alter ego directly in an action for breach of contract. Another procedural vehicle is to first obtain a judgment for breach of contract against the signatories to the contract, followed by a motion to amend the judgment to add the alter egos as defendants (*Code Civ. Proc., § 187*). Still another is, after obtaining a judgment against the signatories, to institute an independent action against the alter egos. These different procedural vehicles, however, are identical in substance: in all three, the proof of alter ego is the same.

CA(5)[] **(5)**

Costs § 25—Attorney Fees—Contract Provisions—Alleged Alter Ego.

Generally, when a judgment is rendered in a case involving a contract that includes an attorney fees and costs provision, the judgment extinguishes all further contractual rights, including the contractual attorney fees clause. That rule is true in general, but not as to an alter ego claim. The reason an alter ego can be added to a judgment is because, in the eyes of the law, the alter ego was a party, albeit by a different name. For a prevailing alleged alter ego, it is as though the alleged alter ego was a party to the original lawsuit, and prevailed. Consequently, a postjudgment action to establish alter ego liability for a judgment on a contract is itself an action on the contract regardless of which procedural vehicle the plaintiff employs.

[*211] ***CA(6)***[] **(6)**

Costs § 25—Attorney Fees—Contract Provisions—Mutuality—Nonsignatory Defendant—Alleged Alter Ego.

Because plaintiff's alter ego action was on the contract and the signatory defendant, the party the nonsignatory defendant was alleged to be the alter ego of, was liable for attorney fees under the contract, the nonsignatory defendant was entitled to attorney fees.

[*Cal. Forms of Pleading and Practice (2020) ch. 174, Costs and Attorney's Fees, § 174.54*; *1 Crompton et al., Matthew Bender Practice Guide: Cal. Contract Litigation (2020) § 12.17*; *2 Cathcart et al., Matthew Bender Practice Guide: Cal. Trial and Post-Trial Civil Procedure (2020) § 25A.08*.]

CA(7)[] **(7)**

Costs § 25—Attorney Fees—Contract Provisions—Voluntary Dismissal of Action.

When a plaintiff files a complaint containing causes of action within the scope of *Civ. Code, § 1717* (that is, causes of action sounding in contract and based on a contract containing an attorney fee provision), and the plaintiff thereafter voluntarily dismisses the action, *§ 1717* bars the defendant from recovering attorney fees incurred in defending those causes of action, even though the contract on its own terms authorizes recovery of those fees.

CA(8)[] **(8)**

Costs § 25—Attorney Fees—Contract Provisions—Voluntary Dismissal of Cause of Action.

Civ. Code, § 1717, subd. (b), does not bar recovery of attorney fees on any particular cause of action when that cause of action is voluntarily dismissed. The section instead bars a prevailing party determination when an action is dismissed (*§ 1717, subd. (b)*). The "action" described in *§ 1717, subd. (b)*, is the action on the contract—the very thing entitling a party to attorney fees under that section (*§ 1717, subd. (a)*).

Counsel: Law Offices of Ted A. Greene and Glen F. Olives for Defendant and Appellant.

Jeppson & Griffin, Tory E. Griffin and Annabel H. Chang for Plaintiff and Respondent.

Judges: Opinion by Robie, J., with Hull, Acting P. J., and Murray, J., concurring.

Opinion by: Robie, J.

Opinion

ROBIE, J.—Plaintiff 347 Group, Inc. (347 Group), sued and obtained a default judgment against defendant Philip Hawkins Architect, Inc. (Architect, **[*212]** Inc.), for breach of contract. Defendants Philip Hawkins, as an individual, and Design-Build, Inc. (Design Build), were also named in the lawsuit, although were not defaulting parties. Instead, 347 Group dismissed its breach of contract cause of action against Hawkins and Design Build but maintained causes of action for fraudulent conveyance and conspiracy, seeking to establish Hawkins and Design Build were alter egos of Architect, Inc., and liable under the contract with Architect, Inc. After Design Build and Hawkins prevailed on those causes of action, they moved for attorney fees. The trial court denied the motion finding an attorney fees award improper because 347 **[**2]** Group dismissed its contract cause of action and the remaining tort causes of action did not allow for an attorney fees award.

On appeal, Hawkins[1] argues the trial court erred and he is entitled to attorney fees because he was sued as an alter ego. We agree and reverse.

FACTUAL AND PROCEDURAL BACKGROUND

347 Group filed suit against Architect, Inc., seeking damages for breach of contract and breach of the covenant of good faith and fair dealing after Architect, Inc., stopped paying for services performed by 347 Group. There was no personal guarantee by Hawkins, who created Architect, Inc., to pay the amount agreed to in the contract, and Design Build was not in existence at the time the contract was entered into. During pendency of the suit, Architect, Inc., declared bankruptcy and Hawkins created Design Build. 347 Group then "filed its second amended complaint which alleged four causes of action: breach of contract, common counts, fraudulent conveyance, and conspiracy," against Architect, Inc., Hawkins, and Design Build.

Thereafter, "[a]t a pretrial conference in chambers before the judge presiding over this matter, [347 Group] requested a default judgment be entered against [Architect, **[**3]** Inc.], and this having been agreed to, stipulated with defense counsel to dismiss the [contract] causes of action against Hawkins and [Design Build]. The stipulation to dismiss the [contract] causes of action was not memorialized in the record of proceedings. However, defense counsel was clearly aware of the dismissal of these claims, and relied on the dismissal in asserting objections during trial." Following trial, the court ruled that Hawkins and Design Build were not liable as alter egos to pay the amount owing under the contract between Architect, Inc., and 347 Group under either a fraudulent conveyance or conspiracy theory.
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Hawkins and Design Build then moved "for attorneys' fees pursuant to *Civil Code section*[2] *1717*." The trial court denied the motion stating: "As [347 Group] voluntarily dismissed the claims 'on the contract' against Hawkins and Design Build, the only remaining causes of action at trial were tort claims for fraudulent conveyance and conspiracy. As to the tort claims, there is no basis for reciprocal fees under … *section 1717*."

Hawkins appeals.

DISCUSSION

I

Hawkins Is Entitled to Attorney Fees

Hawkins contends the trial court erred by finding he was not entitled to attorney fees under *section 1717*. Specifically, **[**4]** Hawkins argues he was entitled to attorney fees under this section because the action, although consisting of only tort claims, was "on the contract" and 347 Group would have been able to collect attorney fees from him in the event it had prevailed. 347 Group disagrees, arguing the action was not "on the contract" because it alleged only tort causes of action and because Hawkins was not identified as a party from whom attorney fees could be recovered under the contract. We agree with Hawkins.

CA(1)[] **(1)** *Section 1717, subdivision (a)*, provides: "In any action on a contract, where the contract specifically provides that attorney's fees and costs, which are incurred to enforce that contract, shall be awarded either to one of the parties or to the prevailing party, then the party who is determined to be the party prevailing on the contract, whether he or she is the party specified in the contract or not, shall be entitled to reasonable attorney's fees in addition to other costs." ***HN1***[] "[O]n a contract" does not mean only traditional breach of contract causes of action. Rather, "California courts 'liberally construe "on a contract" to extend to any action "[a]s long as an action 'involves' a contract and one of the parties would be **[**5]** entitled to recover attorney fees under the contract if that party prevails in its lawsuit … ."'" (*California Wholesale Material Supply, Inc. v. Norm Wilson & Sons, Inc. (2002) 96 Cal.App.4th 598, 605 [117 Cal. Rptr. 2d 390]*.) ***CA(2)***[] **(2)** We review whether a party is entitled to attorney fees under this section de novo, as it is a question of law. (*Gillotti v. Stewart (2017) 11 Cal.App.5th 875, 905 [217 Cal. Rptr. 3d 860]*, review granted Aug. 23, 2017, S242568.)
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Whether a party sued under an alter ego theory is entitled to attorney fees in a breach of contract action was addressed by our Supreme Court in *Reynolds Metals Co. v. Alperson (1979) 25 Cal.3d 124, 127–129 [158 Cal. Rptr. 1, 599 P.2d 83]*. Whether that same party is entitled to attorney fees in an action that does

[1] Design Build did not appeal the trial court's order.

[2] Further section references are to the Civil Code unless otherwise indicated.

not include a breach of contract claim was recently addressed in *MSY Trading Inc. v. Saleen Automotive, Inc. (2020) 51 Cal.App.5th 395, 398–399 [264 Cal. Rptr. 3d 901]*. Because we agree with *MSY Trading* and find its reasoning applicable to this case, we quote heavily from the opinion to explain why Hawkins is entitled to attorney fees.

CA(3)[] **(3)** We begin with the *MSY Trading* court's discussion of *Reynolds Metals*. There, "the plaintiffs sued defendants as the alter egos of the makers of a promissory note. [Citation.] Plaintiffs did not sue the makers because they were insolvent. [Citation.] The alter ego defendants prevailed, and the court awarded their attorney fees based on a provision in the promissory note, though they were not parties to the promissory note. [Citation.] ***HN2***[] Reasoning from the intent of … *section 1717*, which is to ensure mutuality in the availability **[**6]** of attorney fees, our high court held that '[i]ts purposes require … *section 1717* be interpreted to further provide a reciprocal remedy for a nonsignatory defendant, sued on a contract as if he were a party to it, when a plaintiff would clearly be entitled to attorney's fees should he prevail in enforcing the contractual obligation against the defendant.' ([Citation]; see *Brown Bark III, L.P. v. Haver (2013) 219 Cal.App.4th 809, 823 [162 Cal. Rptr. 3d 9]* ['It is well settled a breach of contract claim based on an alter ego theory is still a claim on the contract and a nonsignatory that successfully defends against the claim may recover its attorney fees under … *section 1717*'].)

CA(4)[] **(4)** "*Reynolds Metals* illustrates one of a few procedural vehicles available to a party asserting alter ego liability. ***HN3***[] The first option is to sue the alter ego directly in an action for breach of contract, as occurred in *Reynolds Metals*. Another is to first obtain a judgment for breach of contract against the signatories to the contract, followed by a motion to amend the judgment to add the alter egos as defendants. (See *Misik v. D'Arco (2011) 197 Cal.App.4th 1065, 1074–1075 [130 Cal. Rptr. 3d 123]*; *Code Civ. Proc., § 187*.) Still another is, after obtaining a judgment against the signatories, to institute an independent action against the alter egos, which is the option [347 Group essentially] chose **[**7]** here [by first obtaining a breach of contract judgment against Architect, Inc., and then pursuing alter ego tort claims against Hawkins]. (*Highland Springs Conference & Training Center v. City of Banning (2016) 244 Cal.App.4th 267, 288 [199 Cal. Rptr. 3d 226]* ['As an alternative to filing a [*Code of Civil Procedure] section 187* motion to add a judgment debtor to a judgment, the judgment creditor may file an independent action on the judgment, alleging that the proposed judgment debtor was an alter ego of an original judgment debtor'].) These different procedural **[*215]** vehicles, however, are identical in *substance*: in all three, the proof of alter ego is the same." (*MSY Trading Inc. v. Saleen Automotive, Inc., supra, 51 Cal.App.5th at pp. 402–403*.)

Yet according to 347 Group, a remedy of attorney fees should be available only when a cause of action for breach of contract is reduced to judgment. "We disagree. All of the considerations that led *Reynolds Metals* to permit an alleged alter ego to claim attorney fees under a contract are equally applicable to a postjudgment … action to establish alter ego liability… . [I]f [347 Group] had prevailed in [its] action to deem [Hawkins] an alter ego of [Architect, Inc.], [Hawkins] would have been liable for [any] attorney fee award that was a component of the [contract signed by Architect, Inc].[3] Under the principles of mutuality that inform … *section 1717*, [Hawkins] was entitled **[**8]** to fees as the prevailing party.

CA(5)[] **(5)** "This is true notwithstanding the principle that ***HN4***[] '"[g]enerally, when a judgment is rendered in a case involving a contract that includes an attorney fees and costs provision, the 'judgment extinguishes all further contractual rights, including the contractual attorney fees clause.'"' [Citation.] That rule is certainly true in general, but not as to an alter ego claim. The reason an alter ego can be added to a judgment is because, in the eyes of the law, the alter ego was a party, albeit by a different name. (See *Misik v. D'Arco, supra, 197 Cal.App.4th 1065, 1075* ['Amendment of a judgment to add an alter ego is a proper procedure where it can be shown that the alter ego of the corporate entity had control of the litigation and was virtually represented in the lawsuit'].) To give effect to the principles inherent in *Reynolds Metals* and … *section 1717*, we employ a similar analysis for a prevailing alleged alter ego: it is as though the alleged alter ego was a party to the original lawsuit, and prevailed. Consequently, a postjudgment … action to establish alter ego liability for a judgment on a contract is itself an action on the contract" regardless of which procedural vehicle the plaintiff employs. (*MSY Trading Inc. v. Saleen Automotive, Inc., supra, 51 Cal.App.5th at p. 403*.)

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[3] 347 Group concedes it was entitled to attorney fees under the contract and Architect, Inc., would have been entitled to attorney fees had it prevailed against 347 Group on the contract cause of action.

CA(6)[] **(6)** Accordingly, **[**9]** because 347 Group's alter ego action was on the contract and Architect, Inc., the party Hawkins was alleged to be the alter ego of, was liable for attorney fees under the contract, Hawkins is entitled to attorney fees.
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II

Subdivision (b) of Section 1717 Does Not Apply

347 Group argues Hawkins is not entitled to attorney fees for defending against the voluntarily dismissed contract cause of action because *section 1717, subdivision (b)* bars recovery when a cause of action is dismissed. We disagree.

CA(7)[] **(7)** *Section 1717, subdivision (b)(2)* provides: “Where an action has been voluntarily dismissed or dismissed pursuant to a settlement of the case, there shall be no prevailing party for purposes of this section.” ***HN5***[] Thus, “[w]hen a plaintiff files a complaint containing causes of action within the scope of *section 1717* (that is, causes of action sounding in contract and based on a contract containing an attorney fee provision), and the plaintiff thereafter voluntarily dismisses the action, *section 1717* bars the defendant from recovering attorney fees incurred in defending those causes of action, *even though the contract on its own terms authorizes recovery of those fees*.” (*Santisas v. Goodin (1998) 17 Cal.4th 599, 617 [71 Cal. Rptr. 2d 830, 951 P.2d 399]*.)

CA(8)[] **(8)** ***HN6***[] Contrary to 347 Group's contention, *section 1717, subdivision (b)* does not bar recovery of attorney fees on any particular cause of action when that cause of action is voluntarily **[**10]** dismissed. The section instead bars a prevailing party determination when an “action” is dismissed. (*§ 1717, subd. (b)*.) The “action” described in *section 1717, subdivision (b)* is the action on the contract—the very thing entitling a party to attorney fees under that section. (*§ 1717, subd. (a)*.) As discussed, *ante*, 347 Group did not dismiss the action on the contract. Thus, Hawkins was entitled to a prevailing party determination and whatever attorney fees the contract allows him to recover. We will remand to the trial court for it to consider that issue.

DISPOSITION

The order denying attorney fees is reversed and the matter remanded for the trial court to calculate attorney fees. The parties shall bear their own costs. (*Cal. Rules of Court, rule 8.278(a)(5)*.)

Hull, Acting P. J., and Murray, J., concurred.

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Wolf Metals Inc. v. Rand Pacific Sales Inc.

Court of Appeal of California, Second Appellate District, Division Four

October 25, 2016, Opinion Filed

B264002

Reporter

4 Cal. App. 5th 698 *; 209 Cal. Rptr. 3d 198 **; 2016 Cal. App. LEXIS 896 ***

WOLF METALS INC., Plaintiff and Respondent, v. RAND PACIFIC SALES INC. et al., Defendants and Appellants.

Prior History: [*1]** APPEAL from a judgment of the Superior Court of Los Angeles County, No. VC055239, Roger T. Ito, Judge.

Disposition: Affirmed in part, reversed in part.

Core Terms

Metals, judgment debtor, trial court, bankruptcy proceedings, default judgment, mere continuation, successor corporation, judgment debtor examination, new corporation, alter ego, alter ego theory, underlying action, appellants', transferred, ego, unsecured creditor, amended judgment, arbitration, diligence, litigate, default, modify, amend

Case Summary

Overview

HOLDINGS: [1]-In amending a default judgment pursuant to *Code Civ. Proc., § 187*, the trial court erred in adding a bankrupt corporation's president as a judgment debtor on an alter ego theory; [2]-However, the trial court properly amended the judgment to add a new corporation as the bankrupt corporation's corporate successor; [3]-The records from the bankruptcy proceedings showed only that the new corporation identified itself as an unsecured creditor of the bankrupt corporation; [4]-The bankrupt corporation otherwise failed to respond to plaintiff's post-judgment discovery prior to the judgment debtor examination, which alerted plaintiff to the new corporation's close relationship to the bankrupt corporation; [5]-Thus, the trial court reasonably rejected defendants' contention that plaintiff failed to act with due diligence.

Outcome

Amended judgment affirmed in part and reversed in part.

LexisNexis® Headnotes

Civil Procedure > Parties > Joinder of Parties

Civil Procedure > Parties > Substitution

Civil Procedure > Appeals > Standards of Review > Substantial Evidence

HN1[] **Parties, Joinder of Parties**

Under *Code Civ. Proc., § 187*, the trial court has jurisdiction to modify a judgment to add additional judgment debtors. The decision to modify the judgment is consigned to the trial court's discretion. To the extent the exercise of that discretion relies on factual findings, the appellate court reviews those findings for the existence of substantial evidence.

Business & Corporate Law > ... > Piercing the Corporate Veil > Alter Ego > Fraud & Misrepresentation

Civil Procedure > Judgments > Relief From Judgments > Altering & Amending Judgments

Civil Procedure > Parties > Joinder of Parties

HN2[] **Alter Ego, Fraud & Misrepresentation**

Modification of a judgment to add a defendant may be proper when the newly-named defendant is an existing defendant's alter ego. Under the alter ego doctrine, when the corporate form is used to perpetrate a fraud, circumvent a statute, or accomplish some other wrongful or inequitable purpose, the courts will ignore the corporate entity and deem the corporation's acts to be those of the persons actually controlling the corporation, in most instances the equitable owners. The alter ego doctrine prevents individuals from misusing the corporate laws by the device of a sham corporate entity formed for the purpose of committing fraud or other misdeeds.

Business & Corporate Law > ... > Shareholder Duties & Liabilities > Piercing the Corporate Veil > Alter Ego

Civil Procedure > Judgments > Relief From Judgments > Altering & Amending Judgments

Constitutional Law > Bill of Rights > Fundamental Rights > Procedural Due Process

Civil Procedure > Parties > Joinder of Parties

HN3[] **Piercing the Corporate Veil, Alter Ego**

In the case of default judgments, the application of the alter ego doctrine is subject to a limitation arising from considerations of due process. Under *Code Civ. Proc., § 187*, to amend a judgment to add a defendant, thereby imposing liability on the new defendant without trial, requires both (1) that the new party be the alter ego of the old party and (2) that the new party controlled the litigation, thereby having had the opportunity to litigate, in order to satisfy due process concerns. The due process considerations are in addition to, not in lieu of, the threshold alter ego issues.

Constitutional Law > ... > Fundamental Rights > Procedural Due Process > Scope of Protection

HN4[] **Procedural Due Process, Scope of Protection**

The Fourteenth Amendment guarantees that any person against whom a claim is asserted in a judicial proceeding shall have the opportunity to be heard and to present his or her defenses.

Civil Procedure > Judgments > Relief From Judgments > Altering & Amending Judgments

Constitutional Law > Bill of Rights > Fundamental Rights > Procedural Due Process

Mergers & Acquisitions Law > Liabilities & Rights of Successors > Mere Continuation

Civil Procedure > Parties > Joinder of Parties

Mergers & Acquisitions Law > Liabilities & Rights of Successors > Successor Liability Doctrine

HN5[] **Relief From Judgments, Altering & Amending Judgments**

Modification of a judgment to add a defendant may be proper under the successor corporation theory. According to that theory, when a corporation sells or transfers all of its assets to another corporation constituting its mere continuation, the latter is also liable for the former's debts and liabilities. Generally, California decisions holding that a corporation acquiring the assets of another corporation is the latter's mere continuation and therefore liable for its debts have imposed such liability only upon a showing of one or both of the following factual elements: (1) no adequate consideration was given for the predecessor corporation's assets and made available for meeting the claims of its unsecured creditors; (2) one or more persons were officers, directors, or stockholders of both corporations. In view of the nexus between a corporation and a second corporation constituting its mere continuation, when a judgment is entered against the former due to a failure to present a defense, the judgment may be modified to name the latter as an additional judgment debtor without contravening due process.

Bankruptcy Law > ... > Business & Corporate Compliance > Bankruptcy > Discharge & Dischargeability

HN6[] Bankruptcy Law, Discharge & Dischargeability

A corporation may not discharge its debts and liabilities in a chapter 7 bankruptcy proceeding.

Mergers & Acquisitions Law > Liabilities & Rights of Successors > Successor Liability Doctrine

HN7[] Liabilities & Rights of Successors, Successor Liability Doctrine

Under the successor corporation theory, corporations cannot escape liability by a mere change of name or a shift of assets when and where it is shown that the new corporation is, in reality, but a continuation of the old. When actual fraud or the rights of creditors are involved, under which circumstances the courts uniformly hold the new corporation liable for the debts of the former corporation. The application of the theory presents equitable issues to be examined on their own unique facts.

Civil Procedure > Judgments > Relief From Judgments > Altering & Amending Judgments

Constitutional Law > Bill of Rights > Fundamental Rights > Procedural Due Process

Mergers & Acquisitions Law > Liabilities & Rights of Successors > Mere Continuation

Civil Procedure > Parties > Joinder of Parties

HN8[] Relief From Judgments, Altering & Amending Judgments

When a judgment is entered against a corporation due to its failure to litigate a defense, due process is not contravened by the amendment of the judgment to include a corporation that is the defendant's mere continuation.

Headnotes/Summary

Summary

[*698] CALIFORNIA OFFICIAL REPORTS SUMMARY

Pursuant to *Code Civ. Proc., § 187*, the trial court amended a default judgment entered against a bankrupt corporation and named the bankrupt corporation's president and a new corporation as additional judgment debtors. (Superior Court of Los Angeles County, No. VC055239, Roger T. Ito, Judge.)

The Court of Appeal reversed the amended judgment insofar as it named the bankrupt corporation's president as a defendant, but affirmed the amended judgment in all other respects. The trial court erred in adding the bankrupt corporation's president as a judgment debtor on an alter ego theory. The bankrupt corporation offered no evidence-based defense in the underlying action, and the judgment against it was entered by default. However, the trial court properly amended the judgment to add the new corporation as the bankrupt corporation's corporate successor. The records from the bankruptcy proceedings showed only that the new corporation identified itself as an unsecured creditor of the bankrupt corporation. The bankrupt corporation otherwise failed to respond to plaintiff's postjudgment discovery prior to the judgment debtor examination, which alerted plaintiff to the new corporation's close relationship to the bankrupt corporation. Thus, the trial court reasonably rejected defendants' contention that plaintiff failed to act with due diligence. (Opinion by Manella, J., with Epstein, P. J., and Collins, J., concurring.)

Headnotes

CALIFORNIA OFFICIAL REPORTS HEADNOTES

CA(1)[] (1)

Judgments § 30—Modification—Additional Defendants.

Under *Code Civ. Proc., § 187*, the trial court has jurisdiction to modify a judgment to add additional judgment debtors.

CA(2)[] **(2)**

Corporations § 3—Modification of Judgment—Additional Defendants—Alter Ego Doctrine—Sham Corporate Entity.

Modification of a judgment may be proper when the newly named defendant is an existing defendant's alter ego. Under the alter ego doctrine, when the corporate form is used to perpetrate a fraud, circumvent a statute, or accomplish some other wrongful or inequitable purpose, the courts will ignore the corporate entity and deem the corporation's acts to be those of the persons actually controlling the corporation, in most instances the equitable owners. The alter ego doctrine prevents individuals from misusing the corporate laws by the device of a sham corporate entity formed for the purpose of committing fraud or other misdeeds.

CA(3)[] **(3)**

Corporations § 3—Modification of Judgment—Additional Defendants—Alter Ego Doctrine—Default—Due Process.

In the case of default judgments, the application of the alter ego doctrine is subject to a limitation arising from considerations of due process. Under *Code Civ. Proc., § 187*, to amend a judgment to add a defendant, thereby imposing liability on the new defendant without trial, requires both (1) that the new party be the alter ego of the old party and (2) that the new party controlled the litigation, thereby having had the opportunity to litigate, in order to satisfy due process concerns. The due process considerations are in addition to, not in lieu of, the threshold alter ego issues.

CA(4)[] **(4)**

Constitutional Law § 107—Due Process—Judicial Proceeding—Opportunity to Be Heard—Presentation of Defenses.

U.S. Const., 14th Amend., guarantees that any person against whom a claim is asserted in a judicial proceeding shall have the opportunity to be heard and to present his or her defenses.

CA(5)[] **(5)**

Corporations § 3—Modification of Judgment—Additional Defendants—Mere Continuation—Corporate Successor.

Modification of a judgment to add a defendant may be proper under the successor corporation theory. According to that theory, when a corporation sells or transfers all of its assets to another corporation constituting its mere continuation, the latter is also liable for the former's debts and liabilities. Generally, California decisions holding that a corporation acquiring the assets of another corporation is the latter's mere continuation and therefore liable for its debts have imposed such liability only upon a showing of one or both of the following factual elements: (1) no adequate consideration was given for the predecessor corporation's assets and made available **[*700]** for meeting the claims of its unsecured creditors; (2) one or more persons were officers, directors, or stockholders of both corporations. In view of the nexus between a corporation and a second corporation constituting its mere continuation, when a judgment is entered against the former due to a failure to present a defense, the judgment may be modified to name the latter as an additional judgment debtor without contravening due process.

CA(6)[] **(6)**

Corporations § 3—Modification of Judgment—Additional Defendants—Alter Ego Doctrine—Mere Continuation—Corporate Successor.

In amending a default judgment pursuant to *Code Civ. Proc., § 187*, the trial court erred in adding a bankrupt corporation's president as a judgment debtor on an alter ego theory. However, the trial court properly amended the judgment to add another a new corporation as the bankrupt corporation's corporate successor, as the new corporation was a mere continuation of the bankrupt corporation.

[*Cal. Forms of Pleading and Practice (2016) ch. 161, Corporations: Alter Ego Liability, § 161.14*; 7 Witkin, Cal. Procedure (5th ed. 2008) Judgment, § 66; 9 Witkin, Summary of Cal. Law (10th ed. 2005) Corporations, §§ 9 et seq., 16; 9 Witkin, Cal. Procedure (5th ed. 2008) Appeal, § 701 et seq.]

CA(7)[] **(7)**

Bankruptcy § 5—Discharge—Corporations.

A corporation may not discharge its debts and liabilities in a chapter 7 bankruptcy proceeding.

CA(8)[] **(8)**

Corporations § 3—Modification of Judgment—Additional Defendants—Mere Continuation—Corporate Successor.

Under the successor corporation theory, corporations cannot escape liability by a mere change of name or a shift of assets when and where it is shown that the new corporation is, in reality, but a continuation of the old. When actual fraud or the rights of creditors are involved, under which circumstances the courts uniformly hold the new corporation liable for the debts of the former corporation. The application of the theory presents equitable issues to be examined on their own unique facts.

CA(9)[] **(9)**

Corporations § 3—Modification of Judgment—Additional Defendants—Mere Continuation—Due Process.

When a judgment is entered against a corporation due to its failure to litigate a defense, due process is not contravened by the amendment of the judgment to include a corporation that is the defendant's mere continuation.

Counsel: David S. Kim & Associates, David S. Kim and Arman Matevosyan for Defendants and Appellants. **[*701]**

Ferruzzo & Ferruzzo and James F. Rumm for Plaintiff and Respondent.

Judges: Opinion by Manella, J., with Epstein, P. J., and Collins, J., concurring.

Opinion by: Manella, J.

Opinion

[200]** **MANELLA, J.**—In the underlying action, the trial court entered a default judgment in favor of respondent Wolf Metals Inc., on its complaint against Rand Pacific Sales Inc. (RPS). Following efforts to enforce the judgment, Wolf Metals requested that the judgment be amended to name appellants Donald Koh and South Gate Steel, Inc. (SGS), as additional judgment debtors. The trial court granted the request, concluding that Koh was RPS's alter ego and that SGS was RPS's successor corporation. On appeal, Koh and SGS challenge the amendment to the default judgment. We conclude that pursuant to our Supreme Court's decision in *Motores de Mexicali v. Superior Court (1958) 51 Cal.2d 172 [331 P.2d 1]* (*Motores*), the default judgment could not be amended to add Koh as an alter ego to the judgment. We further conclude that the judgment was properly amended to add **[***2]** SGS as a corporate successor. Accordingly, we reverse the amended judgment in part and affirm it in part.

RELEVANT FACTUAL AND PROCEDURAL BACKGROUND

Wolf Metals's complaint, filed December 23, 2009, asserted claims for open book account, account stated, and breach of contract against RPS. The complaint alleged that from March 2008 to August 2009, Wolf Metals sold sheet metal to RPS pursuant to an oral agreement. The complaint further alleged that RPS owed Wolf Metals the sum of $292,055.93, which RPS had **[**201]** failed to pay despite Wolf Metals's demand. In February 2010, RPS answered the complaint.

In June 2010, RPS filed a petition for chapter 7 bankruptcy protection (*11 U.S.C. § 701 et seq.*). The petition was executed by Koh as RPS's president. As a result of the bankruptcy proceeding, the underlying action was stayed. In the course of the bankruptcy proceeding, Wolf Metals asserted a claim for $298,805.91 as an unsecured creditor on the basis of "[g]oods sold." Koh and SGS also asserted claims as unsecured creditors. On July 14, 2011, the bankruptcy court ordered the case closed. In connection with that order, the docket for the bankruptcy proceeding states, "no discharge." (Capitalization omitted.)

In September 2011, **[***3]** upon notice by Wolf Metals that the bankruptcy proceeding had closed without a discharge, the trial court authorized Wolf Metals to resume litigation of its claims against RPS. After RPS's counsel **[*702]** repeatedly failed to attend scheduled hearings, the court ordered RPS's answer stricken and entered RPS's default. On July 20, 2012, the trial court entered a default judgment in Wolf Metals's favor, awarding $292,055.93 in damages, together with $70,400 in pre-judgment interest and $430.00 in costs.

RPS did not satisfy the judgment. In December 2012, in an effort to enforce the judgment, Wolf Metals arranged for a judgment debtor examination of Koh and his wife, who is RPS's secretary and treasurer. After initially refusing to answer questions, they were examined and excused. Later, when Wolf Metals propounded discovery seeking RPS's records, Koh replied that he had none, stating that all such documents had been transferred to the bankruptcy trustee or discarded. In September 2014, Wolf Metals filed motions to compel responses to its postjudgment special interrogatories and request for the production of documents. The trial court granted the motions and issued an award of sanctions against **[***4]** RPS totaling $1,245. In January 2015, Wolf Metals conducted a second judgment debtor examination of Koh.

Following that examination, Wolf Metals filed a motion under *Code of Civil Procedure section 187*, seeking to amend the default judgment to name Koh and SGS as additional judgment debtors. On March 19, 2015, the trial court issued a written order granting the request, concluding that Koh was RPS's alter ego and that SGS was a successor corporation of RPS. Koh and SGS noticed their appeal from that order. On May 4, 2015, the court entered an amended default judgment naming Koh and SGS as additional judgment debtors.[1]

DISCUSSION

Koh and SGS contend the trial court erred in amending the default judgment to include them as judgment debtors. For the reasons discussed below, we agree that under controlling authority Koh was improperly named a judgment debtor on an "alter ego" theory, but conclude that SGS was properly named as a **[***5]** judgment debtor as RPS's successor corporation.

[*703]

[202]** A. *Governing Principles*

HN1[] ***CA(1)***[] **(1)** Under *Code of Civil Procedure section 187*, "the trial court has jurisdiction to modify a judgment to add additional judgment debtors."[2] (*McClellan, supra, 89 Cal.App.4th at p. 752*.) The decision to modify the judgment is consigned to the trial court's discretion. (*Greenspan v. LADT LLC (2010) 191 Cal.App.4th 486, 508 [121 Cal. Rptr. 3d 118]*.) To the extent the exercise of that discretion relies on factual findings, we review those findings for the existence of substantial evidence. (*McClellan, supra, 89 Cal.App.4th at pp. 751–752*.)

1. *Addition of Judgment Debtor as Alter Ego*

HN2[] ***CA(2)***[] **(2)** Modification of a judgment may be proper when the newly named defendant is an existing defendant's alter ego. (*McClellan, supra, 89 Cal.App.4th at pp. 752–757*.) "Under the alter ego doctrine, … when the corporate form is used to perpetrate a fraud, circumvent a statute, or accomplish some other wrongful or inequitable purpose, the courts will **[***6]** ignore the corporate entity and deem the corporation's acts to be those of the persons … actually controlling the corporation, in most instances the equitable owners. [Citations.] The alter ego doctrine

[1] Appellants' notice of appeal was premature, as only the amended default judgment is appealable. (See *McClellan v. Northridge Park Townhome Owners Assn. (2001) 89 Cal.App.4th 746, 751 [107 Cal. Rptr. 2d 702]*.) However, because Wolf Metals has not objected to the premature notice of appeal, we find good cause to treat the notice as having been filed immediately after the May 4, 2015 judgment. (***Cal. Rules of Court, rule 8.104(d)(2)***; *Stonewall Ins. Co v. City of Palos Verdes Estates (1996) 46 Cal.App.4th 1810, 1827–1828 [54 Cal. Rptr. 2d 176]*; see *McClellan, supra, 89 Cal.App.4th at p. 751*.)

[2] *Code of Civil Procedure section 187* provides: "When jurisdiction is, by the Constitution or this Code, or by any other statute, conferred on a Court or judicial officer, all the means necessary to carry it into effect are also given; and in the exercise of this jurisdiction, if the course of proceeding be not specifically pointed out by this Code or the statute, any suitable process or mode of proceeding may be adopted which may appear most conformable to the spirit of this code."

prevents individuals … from misusing the corporate laws by the device of a sham corporate entity formed for the purpose of committing fraud or other misdeeds. [Citation.]" (Sonora Diamond Corp. v. Superior Court (2000) 83 Cal.App.4th 523, 538 [99 Cal. Rptr. 2d 824].)

HN3[] CA(3)[] **(3)** In the case of default judgments, the application of the alter ego doctrine is subject to a limitation arising from considerations of due process. Under Code of Civil Procedure section 187, "to amend a judgment to add a defendant, thereby imposing liability on the new defendant without trial, requires *both* (1) that the new party be the alter ego of the old party *and* (2) that the new party … controlled the litigation, thereby having had the opportunity to litigate, in order to satisfy due process concerns. The due process considerations are in addition to, *not in lieu of*, the threshold alter ego issues." (Triplett v. Farmers Ins. Exchange (1994) 24 Cal.App.4th 1415, 1421 [29 Cal. Rptr. 2d 741].)

CA(4)[] **(4)** The due process-related requirement was first recognized by our Supreme Court in Motores, supra, 51 Cal.2d 172. There, three individuals **[*704]** formed a corporation that engaged in the sale of used cars. (Id. at pp. 173–174.) When the plaintiff sued the corporation for failure to pay **[***7]** some loans, neither the corporation nor the individuals operating it appeared in the action, and a default judgment was entered against the corporation. (*Ibid.*) When the plaintiff sought to modify the default judgment to include the three individuals as judgment debtors on an alter ego theory, the trial court declined to do so. (Id. at p. 176.) Affirming that ruling, the court concluded that the Fourteenth Amendment of the United States Constitution precluded the modification, stating: HN4[] "That constitutional provision guarantees that any person against whom a claim is asserted in a judicial proceeding shall have the opportunity to **[**203]** be heard and to present his defenses. [Citations.] To summarily add [the three individuals] to the judgment heretofore running only against [the corporation] without allowing them to litigate any questions beyond their relation to the allegedly *alter ego* corporation would patently violate this constitutional safeguard. … They were under no duty to appear and defend personally in that action, since no claim had been made against them personally." (Motores, supra, at p. 176.)

In NEC Electronics Inc. v. Hurt (1989) 208 Cal.App.3d 772, 775–781 [256 Cal. Rptr. 441] (*NEC Electronics*), the appellate court reached a similar conclusion, even though the pertinent judgment arose from the corporate defendant's failure to litigate its defenses **[***8]** at trial, rather than from a default. When the plaintiff sued the corporation for nonpayment of purchased goods, the corporation filed a general denial. (Id. at p. 775.) Prior to trial, the corporation's chief executive officer—who was also its sole shareholder—discussed the corporation's potential bankruptcy and reorganization with the plaintiff. (*Ibid.*) Shortly before trial, the corporation gave notice that it would not appear. (Id. at pp. 775–776.) After the plaintiff presented its evidence at trial, a judgment was entered in its favor against the corporation, which filed a bankruptcy petition. (Id. at p. 776.) Later, after the bankruptcy proceeding closed, the trial court granted the plaintiff's petition to add the corporation's chief executive officer as a judgment debtor, reasoning that he knew of the lawsuit and was involved in the corporation's decisions regarding it. (*Ibid.*) Relying on *Motores*, the appellate court reversed, concluding that the chief executive officer neither shared the corporation's interests nor controlled its defense. (Id. at pp. 780–781.) The court remarked: "There was no defense for [him] to control. After [the corporation] filed its general denial, no further proceedings were conducted." (Id. at p. 781.)

2. *Addition of Judgment **[***9]** Debtor As Successor Corporation*

HN5[] CA(5)[] **(5)** Modification of a judgment may also be proper under the "successor corporation" theory. (McClellan, supra, 89 Cal.App.4th at pp. 753, 754–756, italics omitted.) According to that theory, when a corporation sells or transfers **[*705]** all of its assets to another corporation constituting its "'mere continuation,'" the latter is also liable for the former's debts and liabilities. (Id. at p. 754, fn. 4, quoting Ray v. Alad Corp. (1977) 19 Cal.3d 22, 29 [136 Cal. Rptr. 574, 560 P.2d 3].) Generally, "'California decisions holding that a corporation acquiring the assets of another corporation is the latter's mere continuation and therefore liable for its debts have imposed such liability only upon a showing of one or both of the following factual elements: (1) no adequate consideration was given for the predecessor corporation's assets and made available for meeting the claims of its unsecured creditors; (2) one or more persons were officers, directors, or stockholders of both corporations. [Citations.]'" (McClellan, supra, 89 Cal.App.4th at p. 754, fn. 4, quoting Ray, supra, 19 Cal.3d at p. 29.)

In view of the nexus between a corporation and a second corporation constituting its "'mere continuation,'" when a judgment is entered against the former due to a failure to present a defense, the judgment may be modified to name the latter as an additional judgment debtor without contravening due **[***10]** process. (*McClellan, supra, 89 Cal.App.4th at pp.* ***[**204]*** *754, fn. 4 & 754–757*.) In *McClellan*, a corporation hired a contractor to repair its condominium complex. (*Id. at p. 749*.) After the corporation did not pay for the services, the contractor initiated an arbitration proceeding against it. (*Ibid.*) When the corporation failed to appear at the arbitration, the arbitrator issued a default award, and the contractor filed a petition for a judgment confirming the award. (*Ibid.*) Shortly before that judgment was entered, the corporation's board of directors caused the creation of a new corporation and transferred the condominium complex to it. (*Id. at p. 750*.) Later, the trial court granted the contractor's request to modify the judgment to include the new corporation as a judgment debtor, finding that it was the original corporation's successor. (*Id. at p. 751*.)

Affirming, the appellate court concluded that the new corporation was the original corporation's “mere continuation.” (*McClellan, supra, 89 Cal.App.4th at pp. 755–756*.) In so concluding, the court observed that both corporations shared the same board, which had transferred the condominium complex in contravention of the applicable covenants, conditions, and restrictions, and never dissolved the original corporation. (*McClellan, supra, 89 Cal.App.4th at pp. 755–756*.) The court rejected a contention under *NEC Electronics* that **[***11]** the new corporation lacked the opportunity to litigate in the underlying action, stating: “[The new corporation] was a mere continuation of the [original corporation] under a different name. Therefore, [the new corporation] cannot be heard to complain that because it did not exist at the time the arbitration award was entered, its interests were not represented in the underlying action.” (*Id. at p. 757*.)

[*706]

B. *Underlying Proceedings*

At the January 2015 judgment debtor examination, Koh testified as RPS's president. According to Koh, RPS's board of directors consisted of Koh and his wife, who also served as RPS's secretary and treasurer. The sole shareholder was a Koh family trust. RPS engaged in “[s]teel purchase and sales,” that is, it bought steel coil from suppliers, including Wolf Metals, cut the coil, and then sold it as a finished product. RPS always conducted its operations at a single location, and had 10 to 20 employees.

Koh also operated SGS. As with RPS, Koh's wife acted as SGS's secretary and treasurer. While RPS was active, SGS supplied steel to RPS and cut the steel for RPS. Koh denied that SGS engaged in the same business as RPS.

In the course of RPS's operations, Koh and RPS made loans to each **[***12]** other. At some point, RPS secured a loan from Koh, and discharged the loan by transferring equipment valued at $29,000 to him. According to Koh, no document expressly established the existence of the loan. He further testified that he had no records for RPS because they had been discarded or transferred to the bankruptcy trustee.

In 2010, upon initiating bankruptcy proceedings, RPS stopped doing business and sold its remaining inventory. During the proceedings, SGS asserted an unsuccessful claim for $11,458 as an unsecured creditor.

After the bankruptcy closed, RPS never resumed operations. Koh described its current status as “[n]othing” because it had filed no tax returns for several years. He further stated that because RPS had been “thrown away,” SGS had taken possession of RPS's remaining furniture and other items, which he described as “abandoned.” When asked whether SGS employed any of **[**205]** RPS's employees, Koh replied, “Yes.” Koh testified that RPS would neither satisfy the judgment nor pay the sanctions owed to Wolf Metals, stating that RPS was “no longer there” and that he was “not [RPS] anymore.”

Following the January 2015 judgment debtor examination, Wolf Metals filed its motion to amend **[***13]** the default judgment, contending that Koh and SGS were RPS's alter egos and that SGS was a mere continuation of RPS. In addition to Koh's testimony at the January 2015 examination, Wolf Metals submitted evidence that SGS was engaged in the same business as RPS at its former location, and that Koh was the agent for service of both entities. Wolf Metals's showing included photos of RPS's building in 2007 and photos of the same building in 2014, which then served as SGS's business location. In 2007, the building's front sign displayed RPS's name, two phone numbers, and the following description of its services: “Specialist on narrow cut slit **[*707]** coils … Max capacities ¼ thick to ½” width … Round edged flat bars & coils.” In 2014, when SGS occupied the building, RPS's name was absent, but the building's front sign was otherwise unchanged, and advertised the same services. Wolf Metals also submitted an image of SGS's Web site as it appeared in 2011. The description of SGS's services on the Web site closely tracked the advertisement on the building's front sign.

Appellants' opposition neither disputed Wolf Metals's evidentiary showing nor offered new evidence. In addition to contending **[***14]** that the proposed amendments were improper under *Motores* and *NEC Electronics*, appellants argued that Wolf Metals failed to act with due diligence in seeking the amendments.

In granting the motion to amend the default judgment, the trial court found that Koh and SGS were RPS's alter egos and that SGS was RPS's successor. The court rejected appellants' contention that Wolf Metals had failed to act with due diligence, stating that RPS did not respond to the postjudgment discovery propounded by Wolf Metals, which "learned of the extent to which … [SGS] stepped into the shoes of [RPS] at the January 2015 debtor's examination."

C. *Analysis*

CA(6)[] **(6)** As explained below, we conclude (1) that under *Motores*, Koh was improperly added as a judgment debtor on an "alter ego" theory, and (2) that SGS was properly added as a judgment debtor as a mere continuation of RPS.

1. *No Discharge in the Bankruptcy Proceeding*

At the threshold, we examine appellants' contention that the trial court's ruling contravenes a determination by the bankruptcy trustee and the bankruptcy court. Appellants rely on the bankruptcy trustee's final report prior to the closing of the bankruptcy proceeding, which states: "I have made a **[***15]** diligent inquiry into the financial affairs of the debtor … [RPS.] … [T]here is no property available for distribution from the estate over and above that exempted by law. … I hereby certify that the estate of the above-named debtor(s) has been fully administered. … Claims scheduled to be discharged without payment. … : $286,469.47." Notwithstanding the entry in the bankruptcy court's docket reflecting that the proceeding closed with "no discharge," appellants argue that the trustee's report establishes the existence of a ruling that Wolf Metals's claims against RPS were "to be discharged without payment." (Underscoring omitted.)

CA(7)[] **(7)** Appellants' contention fails, as no such ruling is available in a chapter 7 bankruptcy proceeding. *Section 727(a)(1) of title 11 of the United* ***[*708]*** *States Code* **[**206]** expressly states: "The court shall grant the debtor a discharge, unless … [¶] the debtor is not an individual." Thus, ***HN6***[] a corporation may not discharge its debts and liabilities in a chapter 7 proceeding. (*N.L.R.B. v. Better Bldg. Supply Corp. (9th Cir. 1988) 837 F.2d 377, 378*.)

As such a proceeding also does not dissolve a corporation—which must be accomplished under state procedures—corporate debts and liabilities survive the closing of the bankruptcy proceeding. (*N.L.R.B. v. Better Bldg. Supply Corp., supra, 837 F.2d at p. 379*.) For that reason, responsibility for those debts **[***16]** and liabilities may be imposed on other parties under "alter ego" and "successor corporation" theories. (*Id. at pp. 379–380*; *In re Goodman (2d Cir. 1989) 873 F.2d 598, 602*.) Accordingly, the bankruptcy proceeding did not preclude the amendment of the judgment to include appellants as judgment debtors.[3]

2. *Judgment Improperly Amended Under Alter Ego Theory*

We turn to appellants' contention that the judgment was erroneously amended to include Koh as a judgment debtor on the basis **[***17]** of an alter ego theory. That amendment was improper under *Motores*, which involved facts materially identical to those presented here. Like the defendant corporation in *Motores*, RPS offered no evidence-based defense in the underlying action, and the judgment against RPS was entered by default.[4] Although Koh dominated RPS and knew of

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[3] For the first time on appeal, appellants' reply brief contends the "findings" of the bankruptcy trustee precluded Wolf Metals from asserting that SGS is a mere continuation of RPS. Because they did not raise this contention in their opening brief, they have forfeited it. (*Campos v. Anderson (1997) 57 Cal.App.4th 784, 794, fn. 3 [67 Cal. Rptr. 2d 350]*; 9 Witkin, Cal. Procedure (5th ed. 2008) Appeal, § 701, pp. 769–771.) Moreover, were we to address it, we would reject it. Under the doctrine of collateral estoppel, a finding from a prior proceeding has preclusive effect with respect to an issue only when that issue was "actually litigated" and "necessarily decided" in the prior proceeding. (*People v. Garcia (2006) 39 Cal.4th 1070, 1077 [48 Cal. Rptr. 3d 75, 141 P.3d 197]*; see *Chinese Yellow Pages Co. v. Chinese Overseas Marketing Service Corp. (2008) 170 Cal.App.4th 868, 888 [88 Cal. Rptr. 3d 250]* [bankruptcy court's ruling had no preclusive effect regarding issues not actually adjudicated].) Nothing before us suggests that those requirements were satisfied here.

[4] We recognize that unlike the defendant corporation in *Motores*, RPS filed an answer that was later stricken. However, that factual difference is not material in view of *NEC Electronics*, in which the defendant corporation filed an answer but failed to present an evidence-based defense before judgment was entered against it. (*NEC Electronics, supra, 208*

Wolf Metals's suit against RPS, his circumstances do not differ from the individuals who dominated the defendant corporation in *Motores*. Because *Motores* held that the latter individuals were **[*709]** improperly added as judgment debtors, it precludes the inclusion of Koh as judgment debtor on an alter ego theory.[5]

The decisions upon which Wolf Metals relies are distinguishable, as in each case, the original corporate defendant presented an evidence-based defense prior to the **[**207]** amendment of the judgment. (*Schoenberg v. Romike Properties (1967) 251 Cal.App.2d 154, 166–167 [59 Cal. Rptr. 359]* [judgment properly amended to include defendant corporation's shareholders and officers following jury trial]; *Farenbaugh & Son v. Belmont Construction, Inc. (1987) 194 Cal.App.3d 1023, 1026–1031 [240 Cal. Rptr. 78]* [judgment properly amended to include defendant corporation's president following bench trial]; *Toho-Towa Co., Ltd. v. Morgan Creek Productions, Inc. (2013) 217 Cal.App.4th 1096, 1110 [159 Cal. Rptr. 3d 469]* [arbitration-based judgment against two corporations properly amended to include additional corporation as judgment debtor, as arbitration was contested].) As explained above, RPS offered no defense to Wolf Metals's suit, and the judgment against it was entered by default. Accordingly, the trial court erred in amending the default judgment to include appellants as judgment debtors on the basis of an "alter ego" theory.

3. *Judgment Properly Amended With Respect to SGS Under "Successor Corporation" Theory*

CA(8)[] **(8)** We reach the contrary conclusion regarding the amendment relating to SGS based on the "successor corporation" theory. ***HN7***[] Under that theory, "'corporations cannot escape liability **[***19]** by a mere change of name or a shift of assets when and where it is shown that the new corporation is, in reality, but a continuation of the old. Especially is this well settled when actual fraud or the rights of creditors are involved, under which circumstances the courts uniformly hold the new corporation liable for the debts of the former corporation.'" (*Cleveland v. Johnson (2012) 209 Cal.App.4th 1315, 1327 [147 Cal. Rptr. 3d 772]* (*Cleveland*), quoting *Blank v. Olcovich Shoe Corp. (1937) 20 Cal.App.2d 456, 461 [67 P.2d 376]*.) The application of the theory presents "'equitable issues to be examined 'on their own unique facts … .'" (*Cleveland, supra, 209 Cal.App.4th at p. 1330*, quoting *CenterPoint Energy, Inc. v. Superior Court (2007) 157 Cal.App.4th 1101, 1122 [69 Cal. Rptr. 3d 202]*.)

Here, the evidence establishes that although SGS's creation predated RPS's bankruptcy proceeding, SGS merely continued RPS's business operations **[*710]** under a different name. According to Wolf Metals's showing, Koh "ran" both corporations, which share the same president, secretary, treasurer, business location, and agent for service. After the bankruptcy proceeding closed, RPS was never dissolved. SGS took possession of RPS's remaining assets and offered services identical to those provided by RPS, using RPS's employees. Koh testified that RPS had been "thrown away" and was "no longer there," and that he was "not [RPS] anymore." Wolf Metals's evidence also showed that prior to RPS's bankruptcy, **[***20]** Koh obtained RPS's equipment as the purported repayment of a loan to RPS. As the trial court observed, at the January 2015 judgment debtor examination, Koh was unable to explain his transactions with RPS and SGS "whereby the funds and assets of [RPS] were com[m]ingled with [those] of [SGS] and his own personal finances." In view of this evidence, the court reasonably concluded that SGS was a mere continuation of RPS.

CA(9)[] **(9)** Appellants contend the trial court violated SGS's due process rights in amending the default judgment because SGS's interests differed from RPS's interests in the underlying action, and it lacked control over RPS's defense. In our view, that contention fails in light of *McClellan*, which concluded that ***HN8***[] when a judgment is entered against a corporation due to its failure to litigate a defense, due process is not contravened **[**208]** by the amendment of the judgment to include a corporation that is the defendant's mere continuation. (*McClellan, supra, 89 Cal.App.4th at pp. 756–757*.)

In a related contention, appellants suggest that there was no evidence that SGS paid inadequate consideration for the assets it received from RPS. Inadequacy of consideration, however, is not required for the application of the "'successor corporation'" theory. (**[***21]** *Cleveland, supra, 209 Cal.App.4th at*

Cal.App.3d at pp. 775–781.)

[5] Wolf Metals argues that declining to recognize Koh as a judgment debtor would encourage alter egos of corporations to avoid corporate liabilities by ensuring that the corporations default in actions against them. While we recognize **[***18]** the merits of that policy consideration, the rule established in *Motores* over half a century ago is binding on us. (*Auto Equity Sales, Inc. v. Superior Court (1962) 57 Cal.2d 450, 455 [20 Cal. Rptr. 321, 369 P.2d 937]*.)

pp. 1332, 1333–1334.) Furthermore, the record discloses evidence sufficient to establish that factor. Following RPS's bankruptcy proceeding, SGS simply took possession of RPS's remaining furniture and other items. In addition, prior to the bankruptcy proceeding, Koh secured equipment from RPS valued at $29,000, a sum that exceeds the $11,458 claim that SGS asserted in the proceeding. Koh provided no document establishing the existence of the purported loan underlying the transfer of the equipment. As the record shows that contrary to Koh's testimony, SGS operated in a manner identical to RPS at RPS's business location, the trial court reasonably could have concluded that Koh's purported acquisition of the equipment was, in fact, a consideration-free transfer of equipment to SGS.

Pointing to *McIntire v. Superior Court (1975) 52 Cal.App.3d 717 [125 Cal. Rptr. 379]*, appellants contend the trial court erred in determining that Wolf Metals exercised due diligence in seeking the amendment relating to SGS. In *McIntire*, following the dismissal of fictitious defendants and the **[*711]** presentation of evidence at trial, the plaintiffs entered into a settlement with the named defendants, which the court approved. (*McIntire, supra, 52 Cal.App.3d at p. 717*.) After the time for an appeal from the approval passed, the plaintiffs sought **[***22]** to amend the complaint to name as defendant an individual who had testified at trial. (*Id. at pp. 719–721*.) The appellate court held that any such amendment was improper, as the plaintiffs were aware of the individual's potential involvement in the action before trial. (*Id. at p. 721*.) Relying on *McIntire*, appellants argue that the amendment relating to SGS was improper because Wolf Metals conducted business with Koh before RPS's bankruptcy proceedings, in which Wolf Metals, Koh, and SGS asserted claims.

We reject that contention, as nothing suggests that prior to Koh's January 2015 judgment debtor examination, Wolf Metals knew, or should have known, that SGS was a mere continuation of RPS. The records from the bankruptcy proceedings show only that SGS identified itself as an unsecured creditor of RPS. Although Wolf Metals conducted a judgment debtor examination of Koh and his wife in December 2012, the record does not disclose their testimony. As the trial court observed, RPS otherwise failed to respond to Wolf Metals's postjudgment discovery prior to the January 2015 judgment debtor examination, which alerted Wolf Metals to SGS's close relationship to RPS. The trial court thus reasonably rejected appellants' contention **[***23]** that Wolf Metals failed to act with due diligence. In sum, SGS was properly named as a judgment debtor on a successor corporation theory.

DISPOSITION

The amended judgment is reversed insofar as it names Koh as a defendant, and is affirmed in all other respects. The parties are to bear their own costs on appeal.

[209]** Epstein, P. J., and Collins, J., concurred.

A petition for a rehearing was denied November 14, 2016.

End of Document

Lehman v. Superior Court

Court of Appeal of California, Second Appellate District, Division One

November 28, 2006, Filed

No. B193165

Reporter
145 Cal. App. 4th 109 *; 51 Cal. Rptr. 3d 411 **; 2006 Cal. App. LEXIS 1870 ***; 2006 Cal. Daily Op. Service 10869; 2006 Daily Journal DAR 15538

STEPHEN C. LEHMAN et al., Petitioners, v. THE SUPERIOR COURT OF LOS ANGELES COUNTY, Respondent; NANCY HOFFMEIER ZAMORA, Real Party in Interest.

Subsequent History: Subsequent appeal at, Decision reached on appeal by, Remanded by *Zamora v. Lehman, 186 Cal. App. 4th 1, 111 Cal. Rptr. 3d 335, 2010 Cal. App. LEXIS 993 (Cal. App. 2d Dist., 2010)*

Prior History: ORIGINAL PROCEEDINGS in mandate. **[***1]** Superior Court of Los Angeles County, No. BC344804, William F. Highberger, Judge.

Core Terms

common law, cause of action, created by law, fiduciary duty, liability created by statute, statute of limitations, shareholders, subsidiaries, allegations, courts, demurrer, director of a corporation, trial court, italics

Case Summary

Procedural Posture

Petitioners, two directors of a corporation, sought a writ of mandate after respondent Superior Court of Los Angeles County (California) overruled their demurrer to the complaint of real party in interest, the corporation's chapter 7 trustee, that asserted a cause of action for breach of fiduciary duty against them. The directors demurred on the ground that the action was barred by the statute of limitations, specifically *Code Civ. Proc., § 359*.

Overview

The trial court requested interlocutory review of whether *§ 359* applied to the trustee's claim, noting that there was a split of authority on the issue. The court held that *§ 359* governed a fiduciary duty claim where the basis of the directors' liability was first authorized by a statute or the constitution. If the basis of liability existed at common law, it was not "created by law" within the meaning of *§ 359*, even if the common law theory of liability had since been codified. The court concluded that *§ 359* was not applicable because the directors had not shown that their alleged liability was first authorized by a statute or the constitution. In their writ petition, the directors had shown, at most, that some of the trustee's allegations might give rise to liability under various statutes, assuming the existence of facts not in the complaint. That was insufficient to invoke *§ 359*. As to other allegations, the directors argued that liability did not exist at common law, but they failed to identify a statute or constitutional provision that imposed such liability. That, too, was inadequate for purposes of *§ 359* because a "law" within the meaning of *§ 359* had to exist.

Outcome
The court denied the writ petition.

LexisNexis® Headnotes

Civil Procedure > Appeals > Standards of Review > Abuse of Discretion

Civil Procedure > ... > Responses > Defenses, Demurrers & Objections > Demurrers

HN1[] **Standards of Review, Abuse of Discretion**

In reviewing the ruling on a demurrer, an appellate court is guided by long-settled rules. The court treats the demurrer as admitting all material facts properly pleaded, but not contentions, deductions, or conclusions of fact or law. The court also considers matters which may be judicially noticed. When a demurrer is sustained, the court determines whether the complaint states facts sufficient to constitute a cause of action. And when it is sustained without leave to amend, the court decides whether there is a reasonable possibility that the defect can be cured by amendment: if it can be, the trial court has abused its discretion and the court reverses; if not, there has been no abuse of discretion and the court affirms. A complaint fails to state a cause of action where the dates alleged therein establish that the claim is barred by the statute of limitations.

Governments > Legislation > Interpretation

HN2[] **Legislation, Interpretation**

A court should ascertain the intent of the legislature so as to effectuate the purpose of a law. In determining that intent, the court first examines the words of the statute itself. Under the so-called plain meaning rule, courts seek to give the words employed by the legislature their usual and ordinary meaning. However, the plain meaning rule does not prohibit a court from determining whether the literal meaning of a statute comports with its purpose. If the terms of the statute provide no definitive answer, then courts may resort to extrinsic sources, including the ostensible objects to be achieved and the legislative history.

Governments > Legislation > Statute of Limitations > Time Limitations

HN3[] **Statute of Limitations, Time Limitations**

See *Code Civ. Proc., § 359*.

Governments > Legislation > Statutory Remedies & Rights

Governments > Legislation > Statute of Limitations > Time Limitations

HN4[] **Legislation, Statutory Remedies & Rights**

Code Civ. Proc., § 359, does not apply where the basis of liability existed at common law and *Corp. Code, § 309*, codifies the common law. The term "law," as used in *Code Civ. Proc., § 359*, refers to a statute or constitutional provision. The law's origin - whether the liability existed at common law - makes a difference.

Governments > Legislation > Statutory Remedies & Rights

HN5[] **Legislation, Statutory Remedies & Rights**

A liability "created by law" refers to liability that was first authorized by statute or the Constitution, not the common law.

Governments > Legislation > Statute of Limitations > Time Limitations

HN6[] **Statute of Limitations, Time Limitations**

Under *Code Civ. Proc., § 359*, the limitations period on a liability created by law (as opposed to a penalty or forfeiture) begins to run when the liability is created, not when the cause of action accrues, and the time when the plaintiff actually discovers the injury or wrongful act is not dispositive.

Governments > Legislation > Statutory Remedies & Rights

Governments > Legislation > Statute of Limitations > Time Limitations

HN7[] **Legislation, Statutory Remedies & Rights**

As used in *Code Civ. Proc., § 359*, "law" means statutory or constitutional law. And "created" means brought into existence by or made for the first time. By analogy, *Code Civ. Proc., § 338, subd. (a)*, establishes a three-year limitations period for an action upon a liability created by statute, other than a penalty or forfeiture. Courts have held that "liability created by statute" means the liability is embodied in a statutory provision and was of a type which did not exist at common law.

Governments > Legislation > Statutory Remedies & Rights

HN8[] **Legislation, Statutory Remedies & Rights**

A liability is created by statute if it would not exist but for the statute. A liability created by statute is a liability that comes into being solely by statute and one which had no existence prior to the enactment creating it. Where liability would exist in some form irrespective of the statute, it is not a liability created by statute. Any statutory modification, alteration or conditioning of a common-law cause of action which falls short of creating a previously unavailable cause of action does not transform that cause of action into an action upon a liability created by statute. And where a statute merely limits or expands the remedies available for a breach of duty existing at common law, the liability is not created by statute.

Business & Corporate Law > ... > Management Duties & Liabilities > Defenses > General Overview

HN9[] **Management Duties & Liabilities, Defenses**

See *Corp. Code, § 309*.

Business & Corporate Law > ... > Management Duties & Liabilities > Defenses > General Overview

Governments > Legislation > Statutory Remedies & Rights

Business & Corporate Law > ... > Management Duties & Liabilities > Causes of Action > General Overview

HN10[] **Management Duties & Liabilities, Defenses**

Corp. Code, § 309, does not give rise to a liability "created by law." For one thing, the statute does not set forth any duties of a director, fiduciary or otherwise. Rather, it establishes a standard of care and accords directors immunity from liability if they comply with that standard. The statute dictates how a director's duties - whatever they may be - are to be performed if liability is not to attach. The duties themselves must be found elsewhere. Further, the enactment of *§ 309* did not give rise to any new liability. It codified common law principles, in particular the business judgment rule and the ordinarily prudent person standard. Thus, the statute did not create a liability within the meaning of *Code Civ. Proc., § 359*. Consequently, it cannot be said that liability for a breach of fiduciary duty would not exist but for *Corp. Code, § 309*. The liability of a corporate fiduciary for wrongful acts and omissions did not come into being solely by virtue of that statute. *Section 309* was enacted in 1975. A director's fiduciary duty at common law - generally, to act with honesty, loyalty, and good faith - predated the statute by decades.

Governments > Legislation > Statutory Remedies & Rights

HN11[] **Legislation, Statutory Remedies & Rights**

The test of a liability created by statute is whether or not, independent of the statute, the law implies an obligation to do that which the statute requires to be done, and whether, independently of the statute, the right of action exists for a breach of the duty or obligation. This definition has been generally accepted and approved by the majority of the courts of this country.

Business & Corporate Law > ... > Management Duties & Liabilities > Defenses > General Overview

Governments > Legislation > Statute of

Limitations > Time Limitations

HN12[] Management Duties & Liabilities, Defenses

Code Civ. Proc., § 359, does not apply to Corp. Code, § 309.

Civil Procedure > ... > Pleadings > Complaints > General Overview

Governments > Legislation > Statutory Remedies & Rights

Governments > Legislation > Statute of Limitations > Time Limitations

HN13[] Pleadings, Complaints

In determining whether Code Civ. Proc., § 359, applies in a case, a reviewing court engages in a three-step analysis. First, the court examines the complaint to identify the cause or causes of action. Second, the court decides whether any cause of action is based on a statute or the constitution. If not, the court's inquiry is at an end. If so, then, in the third step, the court determines whether the theory of liability existed at common law. If not, § 359 applies to that cause of action.

Governments > Legislation > Statute of Limitations > Time Limitations

HN14[] Statute of Limitations, Time Limitations

To determine the statute of limitations which applies to a cause of action it is necessary to identify the nature of the cause of action, i.e., the gravamen of the cause of action. The nature of the right sued upon and not the form of action nor the relief demanded determines the applicability of the statute of limitations under California's code. What is significant for statute of limitations purposes is the primary interest invaded by a defendant's wrongful conduct.

Civil Procedure > ... > Pleadings > Complaints > Requirements for Complaint

Governments > Legislation > Statute of Limitations > Time Limitations

HN15[] Complaints, Requirements for Complaint

Courts do not exalt form over substance. Civ. Code, § 3528. Thus, a plaintiff cannot avoid Code Civ. Proc., § 359, simply by omitting statutory references from the complaint. Second, if a plaintiff alleges several acts or omissions as grounds for a director's liability, some of which are based on the common law and others on a statute or the constitution, it is preferable to plead those grounds as separate causes of action even if the plaintiff does not know whether the liability existed at common law. Cal. Rules of Court, rules 201(i), 312(g). This will assist the trial court in determining how many causes of action are actually alleged and the bases of liability. Last, a plaintiff cannot circumvent Code Civ. Proc., § 359, by combining common law and statutory or constitutional theories of liability in a single cause of action. Again, substance prevails.

Headnotes/Summary

Summary

CALIFORNIA OFFICIAL REPORTS SUMMARY

Two directors of a corporation petitioned for a writ of mandate after the trial court overruled their demurrer to the complaint of the corporation’s chapter 7 trustee that asserted a cause of action for breach of fiduciary duty against them. The directors demurred on the ground that the action was barred by the three-year statute of limitations, Code Civ. Proc., § 359. Although the trial court overruled the demurrer, it requested interlocutory review of whether § 359 applied to the trustee’s claim, noting that there was a split of authority on the issue. (Superior Court of Los Angeles County, No. BC344804, William F. Highberger, Judge.)

The Court of Appeal denied the petition, holding that a different statute of limitations applied and Code Civ. Proc., § 359, was inapplicable. Section 359 governs a fiduciary duty claim where the basis of the directors’ liability was first authorized by a statute or the Constitution. If the basis of liability existed at common law, it was not “created by law” within the meaning of § 359, even if the common law theory of liability has since

been codified. The court concluded that *§ 359* was not applicable because the directors had not shown that the basis of their alleged liability was first authorized by a statute or the Constitution. In their writ petition, the directors had shown, at most, that some of the trustee's allegations might give rise to liability under various statutes, assuming the existence of facts not in the complaint. That was insufficient to invoke *§ 359*. Nor had the directors established that the liability authorized by those statutes did not exist at common law. As to other allegations, the directors argued that liability did not exist at common law, but they failed to identify a statute or constitutional provision that imposed such liability. That, too, was inadequate for purposes of *§ 359* because a statutory or constitutional basis—a "law" within the meaning of *§ 359*—must exist. (Opinion by Mallano, Acting P. J., with Vogel and Rothschild, JJ., concurring.) **[*110]**

Headnotes

CALIFORNIA OFFICIAL REPORTS HEADNOTES

Classified to California Digest of Official Reports

CA(1)[] **(1)**

Pleading § 26—Demurrer to Complaint—Grounds—Failure to State Cause of Action—Statute of Limitations.

A complaint fails to state a cause of action where the dates alleged therein establish that the claim is barred by the statute of limitations.

CA(2)[] **(2)**

Statutes § 30—Construction—Language—Plain Meaning Rule.

A court should ascertain the intent of the Legislature so as to effectuate the purpose of a law. In determining that intent, the court first examines the words of the statute itself. Under the plain meaning rule, courts seek to give the words employed by the Legislature their usual and ordinary meaning. However, the plain meaning rule does not prohibit a court from determining whether the literal meaning of a statute comports with its purpose. If the terms of the statute provide no definitive answer, then courts may resort to extrinsic sources, including the ostensible objects to be achieved and the legislative history.

CA(3)[] **(3)**

Limitation of Actions § 36—Commencement of Period—Corporate Stockholders and Directors—Liability Created by Statute—.

Code Civ. Proc., § 359, does not apply where the basis of liability existed at common law and *Corp. Code, § 309*, codifies the common law. The term "law," as used in *Code Civ. Proc., § 359*, refers to a statute or constitutional provision. The law's origin—whether the liability existed at common law—makes a difference. *Section 359* does not apply to *Corp. Code, § 309*. In determining whether *§ 359* applies in a case, a reviewing court engages in a three-step analysis. First, the court examines the complaint to identify the cause or causes of action. Second, the court decides whether any cause of action is based on a statute or the Constitution. If not, the court's inquiry is at an end. If so, then, in the third step, the court determines whether the theory of liability existed at common law. If not, *§ 359* applies to that cause of action.

CA(4)[] **(4)**

Statutes § 1—Liability Created by Law—Test.

A liability "created by law" refers to liability that was first authorized by statute or the Constitution, not the common law. The test of a liability created by statute is whether or not, independent of the statute, the law implies an obligation to do that which the statute requires to be done, and whether, independently of the statute, the right of action exists for a breach of the duty or obligation. This definition has been generally accepted and approved by the majority of the courts of the country.

[*111] ***CA(5)***[] **(5)**

Limitation of Actions § 36—Commencement of Period—Corporate Stockholders and Directors—Liability Created by Statute.

As used in *Code Civ. Proc., § 359*, "law" means statutory or constitutional law. And "created" means brought into existence by or made for the first time. Courts have held that "liability created by statute" means the liability is embodied in a statutory provision and was of a type which did not exist at common law. A liability is created by statute if it would not exist but for the statute.

A liability created by statute is a liability that comes into being solely by statute and one which had no existence prior to the enactment creating it. Where liability would exist in some form irrespective of the statute, it is not a liability created by statute. Any statutory modification, alteration or conditioning of a common law cause of action that falls short of creating a previously unavailable cause of action does not transform that cause of action into an action upon a liability created by statute. And where a statute merely limits or expands the remedies available for a breach of duty existing at common law, the liability is not created by statute.

CA(6)[] **(6)**

Corporations § 39—Directors, Officers, and Agents—Liability—Statute—Created by Law.

Corp. Code, § 309, does not give rise to a liability "created by law." For one thing, the statute does not set forth any duties of a director, fiduciary or otherwise. Rather, it establishes a standard of care and accords directors immunity from liability if they comply with that standard. The statute dictates how a director's duties—whatever they may be—are to be performed if liability is not to attach. The duties themselves must be found elsewhere. Further, the enactment of *§ 309* did not give rise to any new liability. It codified common law principles, in particular the business judgment rule and the ordinarily prudent person standard. Thus, the statute did not create a liability within the meaning of *Code Civ. Proc., § 359*. Consequently, it cannot be said that liability for a breach of fiduciary duty would not exist but for *Corp. Code, § 309*. The liability of a corporate fiduciary for wrongful acts and omissions did not come into being solely by virtue of that statute. *Section 309* was enacted in 1975. A director's fiduciary duty at common law—generally, to act with honesty, loyalty, and good faith—predated the statute by decades.

CA(7)[] **(7)**

Limitation of Actions § 17—Period of Limitation—Determining Applicable Statute.

To determine the statute of limitations that applies to a cause of action it is necessary to identify the nature of the cause of action, i.e., the gravamen of the cause of action. The nature of the right sued upon and not the form of action nor the relief demanded determines **[*112]** the applicability of the statute of limitations under California's code. What is significant for statute of limitations purposes is the primary interest invaded by a defendant's wrongful conduct.

CA(8)[] **(8)**

Limitation of Actions § 36—Commencement of Period—Corporate Stockholders and Directors—Statute—Liability at Common Law.

Where, in their writ petition, two corporate directors had shown, at most, that some of plaintiff's allegations might give rise to liability under various statutes, assuming the existence of facts not in the complaint, that was insufficient to invoke *Code Civ. Proc., § 359*. Nor had the directors established that the liability authorized by those statutes did not exist at common law. As to other allegations, the directors argued that liability did not exist at common law, but they failed to identify a statute or constitutional provision that imposed such liability. That, too, was inadequate for purposes of *§ 359*: A statutory or constitutional basis—a law within the meaning of *§ 359*—must exist.

[3 Witkin, Cal. Procedure (2006 supp.) Actions, § 613; 3 Witkin, Cal. Procedure (4th ed. 1996) Actions, § 607; 9 Witkin, Summary of Cal. Law (10th ed. 2005) Corporations, §§ 90–100.]

CA(9)[] **(9)**

Pleading § 16—Complaint—Substance Prevails.

Courts do not exalt form over substance (*Civ. Code, § 3528*). Thus, a plaintiff cannot avoid *Code Civ. Proc., § 359*, simply by omitting statutory references from the complaint. Second, if a plaintiff alleges several acts or omissions as grounds for a director's liability, some of which are based on the common law and others on a statute or the constitution, it is preferable to plead those grounds as separate causes of action even if the plaintiff does not know whether the liability existed at common law (Cal. Rules of Court, rules 201(i), 312(g)). This will assist the trial court in determining how many causes of action are actually alleged and the bases of liability. Last, a plaintiff cannot circumvent *Code Civ. Proc., § 359*, by combining common law and statutory or constitutional theories of liability in a single cause of action.

Counsel: Rutter Hobbs & Davidoff and Frank D. Hobbs for Petitioners.

No appearance for Respondent.

The Ford Law Firm, William H. Ford III, Claudia J. Serviss and Guenther A. Richter for Real Party in Interest.

Judges: Mallano, Acting P. J., with Vogel and Rothschild, JJ., concurring.

Opinion by: Mallano **[*113]**

Opinion

[412]**

MALLANO, Acting P. J.—This original proceeding raises the question of whether the statute of limitations for a liability "created by law" (*Code Civ. Proc., § 359* (*section 359*)) applies to a claim alleging a breach of fiduciary duty by the directors of a corporation.

We conclude that *section 359* governs a fiduciary duty claim where the basis of the directors' liability was first authorized by a statute or the Constitution. If the basis of liability existed at common law, it was not "created by law" within the meaning of *section 359*, even if the common law theory of liability has since been codified.

I

BACKGROUND

The first amended complaint (complaint) alleges as follows. A corporation, e4L, **[**413]** Inc., **[***2]** did business in Los Angeles County and had its principal place of business there. e4L was a direct marketing company that promoted a wide variety of products on television, radio, and the Internet. Each week, it broadcast more than 3,000 half-hour television programs, commonly known as infomercials, throughout the world. e4L's customers used credit cards to pay for purchases.

Stephen C. Lehman, Eric Weiss, and Daniel Yukelson were directors of e4L (directors). The directors controlled and dominated e4L for their own personal benefit by issuing misleading press releases announcing that e4L (1) had raised $ 22 million "when the money was in fact required to repay investments" and (2) had retained Donaldson, Lufkin & Jenrette as financial consultants. The directors also caused or allowed e4L to engage in improper billing procedures. They did not disclose any of these acts.

The directors caused one of e4L's subsidiaries to enter into a loan and security agreement under which the subsidiary obtained a $ 20 million "credit facility" in exchange for a promise to maintain a minimum net worth of $ 11.7 million. The directors caused or permitted the subsidiary's net worth to fall below $ 11.7 **[***3]** million. As a result, the subsidiary defaulted under the agreement.

e4L acquired a 50 percent interest in BuyItNow.com (BuyItNow), a leading Internet retailer featuring a large selection of brand name products and specialty items. The directors transferred more than $ 6.5 million from BuyItNow to e4L "with no invoices [or] management committee consent," **[*114]** commingled the two companies' funds, failed to hold proper board meetings, "[f]ail[ed] to obtain unanimous board consent on several corporate transactions including stock issuances," advertised products for BuyItNow "as seen on TV" when e4L could not fulfill the orders in a timely manner, caused e4L to show a $ 1.1 million accounts receivable from BuyItNow without providing any accounting or billing information to BuyItNow, and improperly billed BuyItNow "to manipulate e4L's EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization)." These actions diminished e4L's investment in BuyItNow, exposed e4L to substantial liability, and harmed its reputation and creditworthiness.

The directors caused or permitted e4L and its subsidiaries to inflate e4L's earnings and net worth artificially by charging customers' credit **[***4]** cards multiple times for a single purchase and by charging customers' credit cards for merchandise e4L did not have in stock. In so doing, the directors violated the "chargeback" limits of the credit card company.

e4L attempted to sell its Asian subsidiaries but that effort failed when the directors allowed the subsidiaries to fall significantly off their operating budgets.

Eventually, e4L lost its ability to fill and ship orders. The directors caused or permitted e4L to sell and transfer its computers to employees for nominal sums.

On or about March 5, 2001, e4L filed for chapter 11 protection under the Bankruptcy Code (11 U.S.C. § 1101 et seq.). The chapter 11 proceeding was subsequently converted to a chapter 7 case (11 U.S.C. § 701 et seq.).

The directors concealed their wrongful acts and omissions. e4L did not discover the acts and omissions until November 22, 2002.

On December 19, 2005, the chapter 7 trustee, Nancy Hoffmeier Zamora (plaintiff), filed the action below, alleging the foregoing facts and a cause of action for breach of fiduciary duty against the directors. An amended pleading was later filed. Defendants **[**414]** Lehman and Weiss **[***5]** demurred to the complaint on the ground that the action was barred by the statute of limitations, specifically section 359, which applies a three-year limitations period to an action against corporate directors based on "a liability created by law." They argued that their alleged liability was "created by law," namely, Corporations Code section 309, which sets forth a director's standard of care in performing his or her duties. Plaintiff filed opposition, arguing for application of section 343 of the Code of Civil Procedure, which states that "[a]n action for relief not hereinbefore provided for must be commenced within four years after the cause of action shall have accrued." **[*115]**

The trial court overruled the demurrer but requested interlocutory review of whether section 359 applied to plaintiff's claim, noting that there was a split of authority on the issue. (Compare Smith v. Superior Court (1990) 217 Cal. App. 3d 950 [266 Cal. Rptr. 253] (*Smith*) with Briano v. Rubio (1996) 46 Cal.App.4th 1167 [54 Cal. Rptr. 2d 408] (*Briano*); see Code Civ. Proc., § 166.1 [trial court may request **[***6]** interlocutory resolution of controlling question of law as to which there are substantial grounds for difference of opinion].)

Lehman and Weiss filed a petition for writ of mandate with this court, arguing that section 359 applied. We issued an order to show cause, established a briefing schedule, and set the matter for oral argument. Having considered the written and oral arguments of the parties, we conclude that section 359 is not applicable because petitioners have not shown that their alleged liability was *first* authorized by a statute or the Constitution. We therefore deny the petition.

II

DISCUSSION

HN1[] **CA(1)**[] **(1)** In reviewing the ruling on a demurrer, "we are guided by long-settled rules. 'We treat the demurrer as admitting all material facts properly pleaded, but not contentions, deductions or conclusions of fact or law. … We also consider matters which may be judicially noticed.' … When a demurrer is sustained, we determine whether the complaint states facts sufficient to constitute a cause of action. … And when it is sustained without leave to amend, we decide whether there is a reasonable possibility that the defect can be cured by amendment: **[***7]** if it can be, the trial court has abused its discretion and we reverse; if not, there has been no abuse of discretion and we affirm." (Blank v. Kirwan (1985) 39 Cal.3d 311, 318 [216 Cal. Rptr. 718, 703 P.2d 58], citations omitted; accord, Code Civ. Proc., § 452.) A complaint fails to state a cause of action where the dates alleged therein establish that the claim is barred by the statute of limitations. (Anderson v. McNally (1957) 150 Cal. App. 2d 778, 783–784 [310 P.2d 975].)

A. *Interpretation of Section 359*

CA(2)[] **(2)** The petition presents a question of statutory interpretation. We follow " '[t]he fundamental rule … that **HN2**[] the court should ascertain the intent of the Legislature so as to effectuate the purpose of the law. …' … In determining that intent, we first examine the words of the statute itself. … Under the so-called 'plain meaning' rule, courts seek to give the words employed by the Legislature their usual and ordinary meaning. … However, the 'plain meaning' rule does not prohibit a court from determining whether the literal **[*116]** meaning of a statute comports with its purpose. … If the terms of the statute provide no **[***8]** definitive answer, then courts may resort to extrinsic sources, including the ostensible objects to be achieved and the legislative history." (Bodell Construction Co. v. Trustees of Cal. State University **[**415]** (1998) 62 Cal.App.4th 1508, 1515–1516 [73 Cal. Rptr. 2d 450], citations omitted.)

Section 359 states: **HN3**[] "This title[, which governs the time for commencing civil actions,] does not affect actions against directors, shareholders, or members of a corporation, to recover a penalty or forfeiture imposed, or to enforce a liability *created by law*; but such actions must be brought within three years after the discovery by the aggrieved party of the facts upon which the penalty or forfeiture attached, or the liability was created." (Italics added.) Our inquiry focuses on the meaning of a liability "created by law" and whether Corporations Code section 309—which requires that directors perform their duties in good faith—gives rise to such liability.

CA(3)[] **(3)** Two Courts of Appeal have previously addressed this issue, reaching different conclusions. In Smith, supra, 217 Cal. App. 3d 950, the court held that section 359 applies to claims based on Corporations Code section 309. **[***9]** In Briano, supra, 46 Cal.App.4th 1167, the court expressly disagreed with *Smith*, concluding that **HN4**[] section 359 does not apply where the basis of liability existed at common law and that Corporations Code section 309 codified the common law. As we explain, *Smith* is inconsistent with the principles announced by our Supreme Court, the Courts of Appeal, and the courts of other jurisdictions. We therefore conclude that *Briano* properly interpreted section 359 and follow *Briano*.

Smith and *Briano* agreed that the term "law," as used in section 359, refers to a statute or constitutional provision. (See Smith, supra, 217 Cal. App. 3d at p. 953; Briano, supra, 46 Cal.App.4th at pp. 1175–1176.) They disagreed as to whether the law's *origin*—whether the liability existed at common law—makes a difference. Under *Briano*, it does. (See 3 Witkin, Cal. Procedure (2006 supp.) Actions, § 613, pp. 239–240.)

Our Supreme Court discussed these points in Coombes v. Getz (1933) 217 Cal. 320 [18 P.2d 939] (*Coombes*), an action predicated on a state constitutional provision (since repealed) **[***10]** that made a director jointly and severally liable for acts of misappropriation committed by another director or officer. (See id. at p. 322, citing Cal. Const., former art. XII, § 3.) The high court stated: "The term 'created by law' as used in section 359 of the Code of Civil Procedure has a somewhat restricted meaning. In one sense every liability giving rise to a cause of action may be said to be a creature of the law. … But in the sense in which the term is used in said code section, it is confined and restricted to a liability which exists by virtue of an express statute, and it **[*117]** does not include nor extend to actions arising under the common law. … It does include, however, a liability arising under the Constitution." (Coombes, supra, 217 Cal. at pp. 333–334, citations omitted.)

Coombes went on to explain: "[T]he liability for misappropriations by a fellow-director[] was something which did not exist at common law, and was brought into existence by said section of the Constitution. Prior to the enactment of said section of the Constitution no such liability existed. Plaintiff's cause of action rests **[***11]** entirely for its validity upon the right given creditors of a corporation by this section of the Constitution. It is, therefore, … an action to recover on a liability created by law." (Coombes, supra, 217 Cal. at p. 335; accord, Hoffman v. Wair (D.Or. 1961) 193 F. Supp. 727, 729.)

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CA(4)[] **(4)** Under *Coombes*, **HN5**[] a liability "created by law" refers to liability that was *first* authorized by statute or the Constitution, not the common law. (See Briano, supra, 46 Cal.App.4th at pp. 1175–1176 [discussing *Coombes*]; People v. Clauson (1964) 231 Cal.App.2d 374, 380–381 [41 Cal. Rptr. 691] [same]; De Malherbe v. Intern. U. of Elevator Constructors (N.D.Cal. 1978) 449 F. Supp. 1335, 1350–1351 [same]; Damiano v. Bunting (1919) 40 Cal.App. 566, 567–569 [181 P. 232] [section 359 barred personal injury action against deceased stockholder because right to pursue stockholder was based on Constitution and did not exist at common law].)

Enacted in 1872, "[s]ection 359 differs from usual statutes of limitation which commence when the cause of action accrues. The history of this section is well known. **[***12]** It was enacted at a time when the state Constitution provided for proportional liability of shareholders (art. XII, § 3, repealed 1930). It was intended to place reasonable limits upon the time within which the direct primary liability of the shareholders could be enforced; suit could be brought by the creditor against the shareholder; and a judgment against the corporation was not a condition of suit. … It was strictly construed and sometimes barred a cause of action before it accrued. … [M]ost of the cases related to the proportional liability of shareholders, and *distinguished this from any common law liability* of shareholders." (Hoover v. Galbraith (1972) 7 Cal.3d 519, 525, fn. & citation omitted, italics added [102 Cal. Rptr. 733, 498

P.2d 981].)[1]

[*13]** In Pourroy v. Gardner (1932) 122 Cal.App. 521 [10 P.2d 815], stockholders brought an action against the directors of a defunct corporation, alleging a **[*118]** violation of the Civil Code, which required that dividends be paid out of "surplus profits." (Id. at pp. 523–524.) The stockholders contended that the corporation had always operated at a loss. (Id. at p. 524.) The court held that the cause of action was barred by section 359, stating: "[T]he right of action against directors of a corporation conferred by … the Civil Code is 'a statutory right pure and simple, having no foundation in contract, nor *existence at common law*.' " (Pourroy v. Gardner, supra, 122 Cal.App. at p. 528, italics added.)

Section 359 may have been modeled after a New York statute with virtually identical language. (See Coombes, supra, 217 Cal. at p. 329.) As explained by that state's highest court, the phrase "liability created by law" "is not such as would have been used, and certainly is not such as is commonly if ever used, … to describe a liability *existing at common law*, independently of any statutory provision. **[***14]** … The phrase 'created by or under the laws of the state' occurs several times in the Code, and is always used in the sense of a thing *brought into existence by or under statute* … ." (Brinckerhoff et al. v. Bostwick et al. (1885) 99 N.Y. 185, 190–191 [1 N.E. 663, 665] (*Brinckerhoff*), italics added; see id. at pp. 191–193 [1 N.E. at pp. 666–667] [discussing legislative history of New York statute]; Gilbert v. Ackerman (1899) 159 N.Y. 118, 121–122 [53 N.E. 753, 753] [" 'liability created by law,' " as used in New York statute of limitations governing actions **[**417]** against corporate directors, does not include liability existing at common law].) Similar statutes in other states have been given the same interpretation. (See Gores v. Field (1901) 109 Wis. 408, 413–414 [84 N.W. 867, 869–870] [" 'liability created by law' " refers to liability created by statute, not common law]; Southern Bell Tel. & Tel. Co. v. Beach (1911) 8 Ga.App. 720, 723–724 [70 S.E. 137, 138–139] [following *Brinckerhoff*].)

CA(5)[] **(5)** Thus, **HN7**[] as used in section 359, "law" means statutory or constitutional law. And "created" means brought **[***15]** into existence by or made for the first time. (See Webster's 3d New Internat. Dict. (2002) p. 532, col. 2 [defining "create"].)

By analogy, section 338, subdivision (a) of the Code of Civil Procedure (section 338(a)) establishes a three-year limitations period for "[a]n action upon a liability *created by statute*, other than a penalty or forfeiture." (Italics added.) Courts have held that "liability created by statute" means " ' "the liability is embodied in a statutory provision *and* was of a type which did not exist at common law." ' " (Jackson v. Cedars-Sinai Medical Center (1990) 220 Cal. App. 3d 1315, 1320 [269 Cal. Rptr. 877]; accord, City of Los Angeles v. Belridge Oil Co. (1954) 42 Cal.2d 823, 833 [271 P.2d 5], app. dism. *(1955) 348 U.S. 907 [99 L.Ed. 711, 75 S. Ct. 292]*; Churchill v. Pac. Improvement Co. **[*119]** (1892) 96 Cal. 490, 492–493 [31 P. 560]; Smith v. Cremins (9th Cir. 1962) 308 F.2d 187, 189–190 & fn. 15 [applying California law]; see 3 Witkin, Cal. Procedure (4th ed. 1996) Actions, § 607, p. 780.)

The phrase "liability created by statute," as used in the statutes of limitations of other states, **[***16]** has been interpreted in the same way, namely, the liability did not exist at common law. (See Preferred Risk Mut. Ins. Co. v. Vargas (1988) 157 Ariz. 17, 19 [754 P.2d 346, 348]; McCormick v. City of Lawrence (2005) 278 Kan. 797, 798–799 [104 P.3d 991, 992]; Royal Ins. Co. v. Roadarmel (2000) 2000 MT 259 [301 Mont. 508, 513, 11 P.3d 105, 108–109]; Aetna Life & Cas Co v. Nelson (1986) 67 N.Y.2d 169, 173–174 [501 N.Y.S.2d 313, 492 N.E.2d 386, 388]; McAuliffe v. W. States Import Co. (1995) 72 Ohio St.3d 534, 537–538 & fn. 3 [1995 Ohio 201, 651 N.E.2d 957, 960]; Lincoln Bank and Trust Co. v. Neustadt (1996) 1996 Okla.Civ.App. 10 [917 P.2d 1005, 1008]; Shelton v. Paris (1953) 199 Or. 365 [261 P.2d 856, 858].)

HN8[] A liability is " 'created by statute' " if it "would not exist *but for* the statute." (Shewry v. Begil (2005) 128 Cal.App.4th 639, 644 [27 Cal. Rptr. 3d 209], italics added; accord, City of Los Angeles v. Belridge Oil Co., supra, 42 Cal.2d at p. 833; Winick Corp. v. General Ins. Co. (1986) 187 Cal. App. 3d 142, 145 [231 Cal. Rptr. 606].) " '[A] **[***17]** liability created by statute … ' is a liability that comes into being solely by statute and one which had no existence prior to the enactment creating it. Where liability would exist in some form irrespective of the statute, it is not '… a liability created by statute.' " (Rondelli v. County of Pima (1978) 120 Ariz. 483, 486

[1] **HN6**[] Under section 359, the limitations period on "a liability created by law" (as opposed to a penalty or forfeiture) begins to run when the liability is "created," not when the cause of action "accrues" (see Hoover v. Galbraith, supra, 7 Cal.3d at pp. 524–525; Richardson v. Craig (1938) 11 Cal.2d 131, 134–135 [77 P.2d 1077]), and the time when the plaintiff actually discovers the injury or wrongful act is not dispositive (see Briano, supra, 46 Cal.App.4th at p. 1174).

[586 P.2d 1295, 1298].) "Any statutory 'modification, alteration or conditioning' of a common-law cause of action which falls short of creating a previously unavailable cause of action does not transform that cause of action into 'an action … upon a liability created by statute.' " (McAuliffe v. W. States Import Co., supra, 72 Ohio St.3d at p. 538 [651 N.E.2d at p. 960]. And where a statute merely limits or expands the remedies available for a breach of duty existing at common law, the *liability* is not created by statute. (See State v. Cortelle Corp. (1975) 38 N.Y.2d 83, 87–88 [378 N.Y.S.2d 654, 341 N.E.2d 223, 225–226]; *State Farm Mutual Ins. Co.* ***[**418]*** *v. Regional Transit Service, Inc. (1980) 79 A.D.2d 858, 859 [434 N.Y.S.2d 486, 487]*.)

In this action, the directors contend that their liability exists, **[***18]** if at all, by virtue of Corporations Code section 309, which provides:

"(a) ***HN9***[] A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the **[*120]** corporation and its shareholders and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

"(b) In performing the duties of a director, a director shall be entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, in each case prepared or presented by any of the following: (1) One or more officers or employees of the corporation whom the director believes to be reliable and competent in the matters presented. (2) Counsel, independent accountants or other persons as to matters which the director believes to be within such person's professional or expert competence. (3) A committee of the board upon which the director does not serve, as to matters within its designated authority, which committee the director **[***19]** believes to merit confidence, so long as, in any such case, the director acts in good faith, after reasonable inquiry when the need therefor is indicated by the circumstances and without knowledge that would cause such reliance to be unwarranted.

"(c) A person who performs the duties of a director in accordance with subdivisions (a) and (b) shall have no liability based upon any alleged failure to discharge the person's obligations as a director. …"

CA(6)[] **(6)** We conclude that ***HN10***[] Corporations Code section 309 does not give rise to a liability "created by law." For one thing, the statute does not set forth *any duties* of a director, fiduciary or otherwise. Rather, it establishes a *standard of care* and accords directors *immunity from liability* if they comply with that standard. (See Legis. Com. com. **[**419]** (1975)—Assem. [Corrected], 23E West's Ann. Corp. Code (1990 ed.) foll. § 309, pp. 149–151; Frances T. v. Village Green Owners Assn. (1986) 42 Cal.3d 490, 506–509 & fns. 13, 14 [229 Cal. Rptr. 456, 723 P.2d 573]; see also Corp. Code, § 7231 [setting forth standard of care identical to § 309].) The statute dictates *how* a **[***20]** director's duties—whatever they may be—are to be performed if liability is not to attach. (See Gaillard v. Natomas Co. (1989) 208 Cal. App. 3d 1250, 1263–1272 [256 Cal. Rptr. 702].) The duties themselves must be found elsewhere. (See 1 Marsh's Cal. Corporation Law (4th ed. 2006) §§ 10.14–10.15[A], 11.02, pp. 10-72 to 10-80, 11-12 to 11-13; Legis. Com. com. (1975)—Assem. [Corrected], 23E West's Ann. Corp. Code, *supra*, foll. § 309, p. 149, 1st par.; Corp. Code, § 300, subd. (a) [directors have duty to manage business and affairs of corporation subject to limitations approved by shareholders].)

Further, the enactment of Corporations Code section 309 did not give rise to any *new* liability. It codified common law principles, in particular the business judgment rule and the "ordinarily prudent person" standard. (See Briano, supra, 46 Cal.App.4th at pp. 1177–1180; Gaillard v. Natomas Co., ***[*121]*** supra, 208 Cal. App. 3d at pp. 1264–1265; Frances T. v. Village Green Owners Assn., supra, 42 Cal.3d at pp. 506–509 & fns. 13, 14; Legis. Com. com. (1975)—Assem. **[***21]** [Corrected], 23E West's Ann. Corp. Code, *supra*, foll. § 309, pp. 149–151.) Thus, the statute did not "create" a liability within the meaning of section 359. (Briano, supra, 46 Cal.App.4th at p. 1175; Gatto v. County of Sonoma (2002) 98 Cal.App.4th 744, 755 [120 Cal. Rptr. 2d 550]; F.D.I.C. v. McSweeney (9th Cir. 1992) 976 F.2d 532, 536, fn. 3.)

Consequently, we cannot say that liability for a breach of fiduciary duty would not exist "but for" Corporations Code section 309. The liability of a corporate fiduciary for wrongful acts and omissions did not come into being solely by virtue of that statute. Corporations Code section 309 was enacted in 1975. (Stats. 1975, ch. 682, § 7, pp. 1516, 1537–1538, eff. Jan. 1, 1977.) A director's fiduciary duty at common law—generally, to act with honesty, loyalty, and good faith—predated the statute by decades. (See Jones v. H. F. Ahmanson & Co. (1969) 1 Cal.3d 93, 106–110 [81 Cal. Rptr. 592, 460

P.2d 464] [discussing common law development of directors' fiduciary duty]; Remillard Brick Co. v. Remillard-Dandini (1952) 109 Cal. App. 2d 405, 419–421 [241 P.2d 66] **[***22]** [same]; Pacific Vinegar etc. Works v. Smith (1904) 145 Cal. 352, 364–367 [78 P. 550] [same]; 9 Witkin, Summary of Cal. Law (10th ed. 2005) Corporations, §§ 90–100, pp. 863–876 [discussing common law fiduciary duty of corporate directors]; 1 Marsh's Cal. Corporation Law, *supra*, §§ 11.02–11.06, 11.11–11.13, pp. 11-12 to 11-60, 11-94 to 11-112 [same]; 3 Fletcher Cyclopedia of the Law of Private Corporations (2002 rev.) §§ 837.50-839, 844.10-899, 1011, pp. 161–195, 202–391, 679–685 [same]; Friedman, Cal. Practice Guide: Corporations (The Rutter Group 2006) ¶¶ 6:243 to 6:252.2, pp. 6-47 to 6-53.16 [discussing directors' fiduciary duty of care and fiduciary duty of loyalty].)

We also disagree with plaintiff's contention that courts will be faced with an overly burdensome task if they have to determine whether a particular theory of liability existed at common law. That analysis has been required under section 338(a), which governs a “liability created by statute,” for more than 50 years. (See People v. Wilson (1966) 240 Cal. App. 2d 574, 575–577 [49 Cal. Rptr. 792].) The courts have had no difficulty with it. (See 3 Witkin, Cal. Procedure, *supra*, **[***23]** Actions, § 607, pp. 780–783 [citing cases where § 338(a) was found to be applicable and not applicable]; 3 Witkin, Cal. Procedure (2006 supp.) Actions, § 607, pp. 235–237 [same].)

Nor has that type of analysis proved difficult or unworkable in any of the numerous other states, cited above, where it is also employed. Indeed, **HN11**[] “ ‘[t]he test of “a liability created by statute” is whether or not “ ‘… independent of the statute, the law implies an obligation to do that which the statute requires to be done, and whether, independently of the statute, the right of action **[*122]** exists for a breach of the duty or obligation … .” …’ … This definition has been generally accepted and approved by the majority of the courts of this country.’ ” (Clark v. Musick (9th Cir. 1980) 623 F.2d 89, 92, fn. 6, quoting Shelton v. Paris, supra, 199 Or. at p. 367.)

For these reasons, we conclude that Briano properly interpreted section 359 and correctly held that **HN12**[] section 359 did not apply to Corporations Code section 309.

B. *Application of Section 359*

HN13[] In determining whether section 359 applies in this case, **[***24]** we engage in a three-step analysis. First, we examine the complaint to identify the cause or causes of action. Second, we decide whether any cause of action is based on a statute or the **[**420]** Constitution. If not, our inquiry is at an end. If so, then, in the third step, we determine whether the theory of liability existed at common law. If not, section 359 applies to that cause of action.

In bringing the demurrer, the directors had the burden of proving that section 359 barred the action. (See Kaiser Foundation Hospitals v. Workers' Comp. Appeals Bd. (1985) 39 Cal.3d 57, 67, fn. 8 [216 Cal. Rptr. 115, 702 P.2d 197]; Samuels v. Mix (1999) 22 Cal.4th 1, 10 [91 Cal. Rptr. 2d 273, 989 P.2d 701].) Put another way, the directors must establish that their alleged liability on the fiduciary duty claim is based on a statute or the Constitution and did not exist at common law.

HN14[] **CA(7)**[] **(7)** “ ‘ “To determine the statute of limitations which applies to a cause of action it is necessary to identify the nature of the cause of action, i.e., the ‘gravamen’ of the cause of action. … ‘[T]he nature of the right sued upon and not the form of action nor the relief demanded determines the applicability of the statute of limitations under **[***25]** our code.’ …” ’ … ‘What is significant for statute of limitations purposes is the primary interest invaded by defendant's wrongful conduct.’ ” (Hydro-Mill Co., Inc. v. Hayward, Tilton & Rolapp Ins. Associates, Inc. (2004) 115 Cal.App.4th 1145, 1153 [10 Cal. Rptr. 3d 582], citations omitted.)

Here, the complaint contains a single cause of action denominated “breach of fiduciary duty.” It alleges in essence that the directors mismanaged e4L to the point of bankruptcy. We have already recited the principal allegations of the complaint: In short, the directors issued misleading press releases about e4L's financial condition, engaged in improper billing procedures, overcharged customers, allowed the net worth of a subsidiary to drop below a contractual minimum, manipulated e4L's earnings through the control of other companies, advertised products e4L did not have, and allowed e4L's computers to be misappropriated by employees. (See pt. I, *ante*.)

[*123]

CA(8)[] **(8)** In their writ petition, the directors have shown, at most, that some of plaintiff's allegations *might* give rise to liability under various statutes, *assuming* the existence of facts *not* in the complaint. That is insufficient to **[***26]** invoke section 359. Nor have the directors established that the liability authorized by those statutes did not exist at common law. [2] As to other allegations, the directors argue that liability did not exist at common law, but they fail to identify a statute or constitutional provision that imposes such liability. That, too, is inadequate for purposes of *section 359*: A statutory or constitutional basis—a "law" within the meaning of *section 359*—must exist.

[*27]** We note that the question before the trial court and this court is whether the complaint is barred by the statute of limitations, not whether plaintiff pleaded a cognizable theory of liability. If the directors wanted to challenge the legal sufficiency of the allegations, they could have raised that issue in the demurrer. To argue now that certain of plaintiff's allegations **[**421]** are not actionable *at all* is not germane to the question raised in the petition.

In sum, the directors have not established at this stage of the litigation that the cause of action for breach of fiduciary duty is *not* based on a liability that existed at common law. But the allegations in the complaint may not yet be fully developed. Nothing precludes the directors from pursuing this issue in discovery or raising it again in an appropriate manner.

CA(9)[] **(9)** Finally, some practical observations are in order. First, ***HN15***[] courts do not exalt form over substance. (See *Civ. Code, § 3528*.) Thus, a plaintiff cannot avoid *section 359* simply by omitting statutory references from the complaint. Second, if a plaintiff alleges several grounds for a director's liability, some of which **[***28]** are based on the common law and others on a statute or the Constitution, it is preferable to plead those grounds as separate causes of action. (See Cal. Rules of Court, rules 201(i), 312(g).) This will assist the trial court in determining how many causes of action are actually alleged and the bases of liability. Last, a plaintiff cannot circumvent *section 359* by combining common law and statutory or constitutional theories of liability in a single cause of action. Again, substance prevails.

[*124]

III

DISPOSITION

The petition is denied. The order to show cause is discharged. The parties to this proceeding are to bear their own costs.

Vogel, J., and Rothschild, J., concurred.

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[2] The directors contend that *all* claims brought against them *on behalf of the corporation* fall within *section 359*, relying on *Frances T. v. Village Green Owners Assn., supra, 42 Cal.3d at pages 506–507*. That case says nothing of the sort but supports our earlier statement that *Corporations Code section 309* codifies common law principles. (See *Frances T., supra, at pp. 506–509 & fns. 13, 14*.) In fact, derivative suits were permitted under the common law. (See *Ross v. Bernhard (1970) 396 U.S. 531, 533–537 & fn. 7 [24 L. Ed. 2d 729, 90 S. Ct. 733 735–737 & fn. 7]*.)

Solution Trust v. 2100 Grand LLC (In re AWTR Liquidation Inc.)

United States Bankruptcy Court for the Central District of California, Los Angeles Division

March 11, 2016, Decided; March 11, 2016, Filed and Entered

CHAPTER 11, Case No.: 2:13-bk-13775-NB, Adv No: 2:15-ap-01095-NB

Reporter

548 B.R. 300 *; 2016 Bankr. LEXIS 896 **; 2016 WL 1128029

In re: AWTR Liquidation Inc., Debtor;SOLUTION TRUST, as Trustee of the AWTR LIQUIDATION TRUST, Plaintiff, v. 2100 Grand LLC, Lee Berger, Prashant Buyyala, CCC Diagnostics LLC, Raymond Feeney, Keith Goldfarb, John Patrick Hughes, Rhythm & Hues Sdn. Bhd, Pauline Ts'o, David Weinberg, Defendants.

Prior History: *Solution Trust v. 2100 Grand LLC (In re AWTR Liquidation Inc.), 547 B.R. 831, 2016 Bankr. LEXIS 894 (Bankr. C.D. Cal., Mar. 11, 2016)*

Core Terms

insolvency, allegations, business judgment rule, stockholders, good faith, fiduciary duty, transactions, decisions, business judgment, equitable, balance sheet, cash flow, motion to dismiss, subordination, self-dealing, shareholders, omissions, complaint alleges, Transfers, Software, allegation of the complaint, inadequate capitalization, liquidity, prima facie, constituent, Rights, reporting system, matter of law, abdication, Reckless

Case Summary

Overview

HOLDINGS: [1]-Liquidating trustee could bring breach of fiduciary duty claims on behalf of creditors with respect to those breaches that occurred when debtor was insolvent or was rendered insolvent; [2]-Complaint adequately pled insolvency by expressly alleging that debtor was insolvent under the balance sheet, cash flow, and inadequate capitalization tests; [3]-With one exception, defendants (directors and/or officers) did not establish that either the exculpatory provisions of debtor's articles of incorporation or the business judgment rule insulated them; [4]-Complaint adequately alleged more than ordinary negligence, as to which the business judgment rule was not a shield; [5]-Complaint stated a claim for corporate waste and equitable subordination; [6]-Trustee's objections to the directors' proofs of claim survived the motion to dismiss.

Outcome

The court granted the motions to dismiss and motions for more definite statement in part and denied them in part.

LexisNexis® Headnotes

Civil Procedure > ... > Defenses, Demurrers & Objections > Motions to Dismiss > Failure to State Claim

HN1[] **Motions to Dismiss, Failure to State Claim**

In the context of motions to dismiss, all well pled and plausible allegations are assumed to be true, and all reasonable inferences are drawn in the non-moving party's favor.

Bankruptcy Law > Procedural Matters > Adversary Proceedings > Commencement of Adversary Proceedings

Civil Procedure > ... > Defenses, Demurrers & Objections > Motions to Dismiss > Failure to State Claim

Civil Procedure > ... > Pleadings > Complaints > Requirements for Complaint

Bankruptcy Law > Procedural Matters > Adversary Proceedings > Defenses & Objections

HN2[] Adversary Proceedings, Commencement of Adversary Proceedings

A motion to dismiss for failure to state a claim upon which relief can be granted is governed by *Fed. R. Civ. P. 12(b)(6)* (incorporated by *Fed. R. Bankr. P. 7012(b)*). *Fed. R. Civ. P. 8(a)(2)* (incorporated by *Fed. R. Bankr. P. 7008*), requires the plaintiff to provide a short and plain statement of the claim showing that the pleader is entitled to relief, in order to give the defendant fair notice of what the claim is and the grounds upon which it rests.

Civil Procedure > ... > Defenses, Demurrers & Objections > Motions to Dismiss > Failure to State Claim

Civil Procedure > ... > Pleadings > Complaints > Requirements for Complaint

HN3[] Motions to Dismiss, Failure to State Claim

To survive a motion to dismiss, a complaint must contain sufficient factual matter, accepted as true, to state a claim to relief that is plausible on its face. A claim has facial plausibility when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged. While a complaint attacked by a *Fed. R. Civ. P. 12(b)(6)* motion to dismiss does not need detailed factual allegations, a plaintiff's obligation to provide the grounds of his entitlement to relief requires more than labels and conclusions, and a formulaic recitation of a cause of action's elements will not do. Determining whether a complaint states a plausible claim for relief is a context-specific task that requires the reviewing court to draw on its judicial experience and common sense.

Civil Procedure > ... > Defenses, Demurrers & Objections > Motions to Dismiss > Failure to State Claim

HN4[] Motions to Dismiss, Failure to State Claim

A motion to dismiss under *Fed. R. Civ. P. 12(b)(6)* challenges the legal sufficiency of a complaint, considered with the assumption that the facts alleged are true. Thus, dismissal for failure to state a claim is proper only where there is no cognizable legal theory or an absence of sufficient facts alleged to support a cognizable legal theory.

Civil Procedure > ... > Defenses, Demurrers & Objections > Motions to Dismiss > Failure to State Claim

HN5[] Motions to Dismiss, Failure to State Claim

The Ninth Circuit has summarized this standard the standard for a motion to dismiss under *Fed. R. Civ. P. 12(b)(6)* as follows: for a complaint to survive a motion to dismiss, the non-conclusory factual content, and reasonable inferences from that content, must be plausibly suggestive of a claim entitling the plaintiff to relief.

Civil Procedure > ... > Pleadings > Heightened Pleading Requirements > Fraud Claims

HN6[] Heightened Pleading Requirements, Fraud Claims

A party alleging fraud must state with particularity the circumstances constituting fraud.

Civil Procedure > ... > Pleadings > Heightened Pleading Requirements > Fraud Claims

HN7[] Heightened Pleading Requirements, Fraud Claims

Fed. R. Civ. P. 9(b) requires that the circumstances constituting the alleged fraud be specific enough to give defendants notice of the particular misconduct so that they can defend against the charge and not just deny that they have done anything wrong. The rule is satisfied if the complaint identifies the who, what, when, where, and how of the alleged misconduct.

Bankruptcy Law > Procedural Matters > Adversary Proceedings > Defenses & Objections

Civil Procedure > ... > Responses > Defenses, Demurrers & Objections > Defects of Form

HN8[] Adversary Proceedings, Defenses & Objections

A party may move for a more definite statement of a pleading to which a responsive pleading is allowed but which is so vague or ambiguous that the party cannot reasonably prepare a response. *Fed. R. Civ. P. 12(e)* (incorporated by *Fed. R. Bankr. P. 7012(b)*). But when the issues involve highly fact-sensitive inquiry, the better practice is to resolve the issues on summary judgment, after full discovery, rather than attempting to do so on a motion for a more definite statement.

Bankruptcy Law > ... > Avoidance > Fraudulent Transfers > Constructively Fraudulent Transfers

Bankruptcy Law > ... > Prepetition Transfers > Voidable Transfers > Unsecured Creditors

Bankruptcy Law > ... > Preferential Transfers > Elements > Debtor Insolvency

HN9[] Fraudulent Transfers, Constructively Fraudulent Transfers

Insolvency is defined by the Bankruptcy Code for purposes of federal avoidance claims under *11 U.S.C.S. §§ 547* and *548*. Insolvency is defined by state law for purposes of state avoidance claims incorporated by *11 U.S.C.S. § 544*.

Civil Procedure > Preliminary Considerations > Federal & State Interrelationships > Erie Doctrine

Governments > Courts > Judicial Precedent

HN10[] Federal & State Interrelationships, Erie Doctrine

When a state's highest court has not decided a state law issue, the federal courts must predict how it would decide the issue by looking to other sources, such as intermediate appellate court decisions, decisions from other jurisdictions, statutes, treatises, and restatements. When there is relevant precedent from the state's intermediate appellate court, the federal court must follow that precedent unless the federal court finds convincing evidence that the state's supreme court likely would not follow it.

Bankruptcy Law > ... > Avoidance > Fraudulent Transfers > Constructively Fraudulent Transfers

Bankruptcy Law > ... > Avoidance > Fraudulent Transfers > Elements

HN11[] Fraudulent Transfers, Constructively Fraudulent Transfers

See *11 U.S.C.S. § 548(a)(1)*.

Bankruptcy Law > ... > Preferential Transfers > Elements > Debtor Insolvency

Civil Procedure > Judgments > Enforcement & Execution > Fraudulent Transfers

HN12[] Elements, Debtor Insolvency

An avoidable preference under *11 U.S.C.S. § 547* includes balance sheet insolvency as one of its elements. *§ 547(b)(3)*. California statutes have similar tests of balance sheet insolvency, cash flow insolvency, and inadequate capitalization. *Cal. Civ. Code §§ 3439.04(a)(1)* and *(2)* and *3439.05*.

Civil Procedure > Judgments > Enforcement & Execution > Fraudulent Transfers

HN13[] Enforcement & Execution, Fraudulent Transfers

See *Cal. Civ. Code § 3439.04(a)*.

Civil Procedure > Judgments > Enforcement & Execution > Fraudulent Transfers

HN14[] **Enforcement & Execution, Fraudulent Transfers**

See *Cal. Civ. Code § 3439.05*.

Civil Procedure > Judgments > Enforcement & Execution > Fraudulent Transfers

HN15[] **Enforcement & Execution, Fraudulent Transfers**

Two tests for insolvency used for fraudulent transfer purposes -- inadequate capital and cash flow/equitable insolvency -- may be seen as different iterations of the same test: inability to pay debts either in the reasonably foreseeable future or more immediately. The Third Circuit has observed, some courts have equated a finding of equitable insolvency (aka cash flow insolvency) with that of unreasonably small capital, but the better view is that unreasonably small capital denotes a financial condition short of equitable insolvency and thus, the test for unreasonably small capital is reasonable foreseeability that lack of capital would lead to an inability to generate enough cash flow to sustain operations.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Care

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Good Faith

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Loyalty

HN16[] **Fiduciary Duties, Duty of Care**

Corporate fiduciary duties typically are divided into three categories (although the last of these may be a sub-category): (1) duty of care -- this is the duty to exercise reasonable prudence in making business judgments for the corporation, including gathering adequate information and undertaking due consideration of the relevant issues; (2) duty of loyalty -- this is the duty to give primacy to the interest of the corporation, most typically contrasted with acting in self-interest; (3) duty of good faith -- this duty of good faith is generally considered part of the duty of loyalty, because directors or officers cannot act loyally towards the corporation unless they act in the good faith belief that their actions are in the corporation's best interest, and this has been held to include a duty of oversight.

Business & Corporate Law > ... > Directors & Officers > Management Duties & Liabilities > Fiduciary Duties

HN17[] **Management Duties & Liabilities, Fiduciary Duties**

It is not entirely clear whether there is any difference between the fiduciary duties for directors and officers. Delaware decisions have held that these basic duties are the same.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Care

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Good Faith

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Loyalty

HN18[] **Fiduciary Duties, Duty of Care**

As part of exercising the duties of care, loyalty, and good faith, directors must monitor for others' wrongdoing. This is often referred to as "Caremark" duties.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Care

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Loyalty

Business & Corporate Law > ... > Management

Duties & Liabilities > Fiduciary Duties > Duty of Good Faith

HN19[] Fiduciary Duties, Duty of Care

The overall goal, in exercising the duties of care, loyalty, and good faith, is to preserve and grow corporate value.

Business & Corporate Law > ... > Directors & Officers > Management Duties & Liabilities > Fiduciary Duties

Torts > Intentional Torts > Breach of Fiduciary Duty > Elements

Torts > Intentional Torts > Breach of Fiduciary Duty > Remedies

HN20[] Management Duties & Liabilities, Fiduciary Duties

The elements of a claim for breach of fiduciary duty by corporate officers and directors are: (1) the existence of a fiduciary relationship, (2) the breach of that relationship, and (3) damages proximately caused by the breach. Remedies include damages for all harm proximately caused to the corporation, as well as rescission and restitution.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Business Judgment Rule

HN21[] Fiduciary Duties, Business Judgment Rule

Normally one who breaches a duty through ordinary negligence is liable for the damages that are proximately caused, but corporate directors are protected by the business judgment rule. That rule is a judicial policy of deference to the business judgment of corporate directors in the exercise of their broad discretion in making corporate decisions.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Business Judgment Rule

HN22[] Fiduciary Duties, Business Judgment Rule

The effect of the business judgment rule is to raise the burden of proof from ordinary negligence to gross negligence -- i.e., failure to exercise even slight care. Put differently, corporate directors will not be held liable for a negligent judgment (i.e., one a reasonably prudent person would not have made) so long as the process leading to the judgment meets business judgment rule requirements. In other words, courts will not second-guess the decisions of disinterested directors made with reasonable diligence in ascertaining the facts and believed to be in the corporation's best interests. This is so even if the directors make a bad or "stupid" decision.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Business Judgment Rule

HN23[] Fiduciary Duties, Business Judgment Rule

The business judgment rule presupposes that judgment -- reasonable diligence -- has in fact been exercised, and a director cannot close his eyes to what is going on about him in the conduct of the business of the corporation and have it said that he is exercising business judgment.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Business Judgment Rule

Evidence > Inferences & Presumptions > Presumptions > Particular Presumptions

HN24[] Fiduciary Duties, Business Judgment Rule

The business judgment rule has been partially codified in Cal. Corp. Code § 309. That statute at first appears to apply a simple negligence standard, but a gross negligence standard applies under the business judgment rule (apparently because, although directors are required to act under a reasonableness standard, the business judgment rule presumes that they have done so unless that presumption can be overcome by a showing of gross negligence).

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Business Judgment Rule

HN25[] **Fiduciary Duties, Business Judgment Rule**

See *Cal. Corp. Code § 309*.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Business Judgment Rule

Governments > Courts > Judicial Precedent

HN26[] **Fiduciary Duties, Business Judgment Rule**

Although no reported decision under California corporate law has expressly followed Caremark, it has been widely accepted and the United States Bankruptcy Court for the Central District of California knows of no reason why the California Supreme Court would not apply the same reasoning.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Business Judgment Rule

HN27[] **Fiduciary Duties, Business Judgment Rule**

Under Caremark, directors must assure themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance. Obviously the level of detail that is appropriate for such an information system is a question of business judgment. And obviously too, no rationally designed information and reporting system will remove the possibility that the corporation will violate laws or regulations, or that senior officers or directors may nevertheless sometimes be misled or otherwise fail reasonably to detect acts material to the corporation's compliance with the law. But it is important that the board exercise a good faith judgment that the corporation's information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations, so that it may satisfy its responsibility.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Business Judgment Rule

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Good Faith

HN28[] **Fiduciary Duties, Business Judgment Rule**

Under Caremark, a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so may render a director liable for losses caused by non-compliance with applicable legal standards.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Business Judgment Rule

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Good Faith

HN29[] **Fiduciary Duties, Business Judgment Rule**

Generally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability-creating activities within the corporation. only a sustained or systematic failure of the board to exercise oversight -- such as an utter failure to attempt to assure a reasonable information and reporting system exits -- will establish the lack of good faith that is a necessary condition to liability.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Business Judgment Rule

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Care

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Good Faith

HN30[] **Fiduciary Duties, Business Judgment Rule**

Caremark articulated directors' duty to attempt "in good faith" to assure the adequacy of information and reporting systems, and the Delaware Supreme Court has held that liability for lack of oversight requires a lack of such good faith in that (1) the directors utterly failed to implement any reporting or information system or controls; or (2) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. The Delaware Supreme Court has also described Caremark as addressing situations in which the fiduciary intentionally fails to act in the face of a known duty to act (i.e., the duty to attempt to establish adequate information and reporting systems), demonstrating a conscious disregard for his duties, which is qualitatively different from, and more culpable than, the conduct giving rise to a violation of the fiduciary duty of care (i.e., gross negligence). Similarly, the Court of Appeal of California stated in Berg that the business judgment rule does not immunize directors for abdication of duty by closing their eyes to what is going on in the conduct of the business.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Business Judgment Rule

Civil Procedure > ... > Pleadings > Complaints > Requirements for Complaint

Evidence > Burdens of Proof > Burden Shifting

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Good Faith

Evidence > Types of Evidence > Circumstantial Evidence

HN31[] Fiduciary Duties, Business Judgment Rule

As explained in Caremark (which was expressly adopted by the Supreme Court of Delaware in Stone), the first step in implementing a reporting or information system is that corporate directors have a duty to attempt in good faith to establish an adequate one, meaning one reasonably designed to provide timely, accurate, and sufficient information. If the allegations in a complaint, accepted as true, establish a prima facie showing that no such system exists, then by definition the directors have utterly failed to implement it and have intentionally failed to act in the face of the known duty to attempt to establish such a system. The burden then would be on the directors either to rebut that prima facie showing or to show that, despite the absence of such a system, they nevertheless made an attempt in good faith to do so. Circumstantial evidence can establish such a prima facie showing that there is no system, such as the complaint's allegations of repeated transactions occurring without any board approval or ratification, when normally such transactions would require such approval. That shifts the burden to the corporation's directors to show either that the complaint's prima facie showing is unfounded or that they did in fact attempt in good faith to establish an "adequate" system.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Business Judgment Rule

Evidence > Burdens of Proof > Burden Shifting

Civil Procedure > ... > Pleadings > Complaints > Requirements for Complaint

Evidence > Types of Evidence > Circumstantial Evidence

HN32[] Fiduciary Duties, Business Judgment Rule

Although there is great deference as to the nature of a reporting or information system (the level of detail is itself a question of business judgment under Caremark) the directors must have actually exercised judgment" in establishing such a system before the business judgment rule applies. For example, if one board member's "system" is simply to assume that other board members will handle his or her responsibilities -- without attempting to confirm that by some reasonable method, such as appropriate delegation to a subcommittee that reports back to the board -- then there would not have been any exercise of business judgment. That is another form of utterly failing to implement a Caremark system. Circumstantial evidence, such as the allegations in the complaint, can establish a prima facie showing that directors of a corporation have not exercised business judgment. That shifts the burden to those directors to rebut that prima facie showing and show that they did in fact exercise their business judgment in attempting in good faith to establish a system that was "reasonably" designed to provide them with timely, accurate, and sufficient information.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Business Judgment Rule

Civil Procedure > ... > Pleadings > Complaints > Requirements for Complaint

Evidence > Types of Evidence > Circumstantial Evidence

HN33[] **Fiduciary Duties, Business Judgment Rule**

Once having set up a reporting or information system, directors are entitled to rely on it. But if they fail to use that system, or choose to ignore its clear flaws, then they have consciously failed to monitor or oversee the corporation's operations thus disabling themselves from being informed of risks or problems requiring their attention. This can be shown by circumstantial evidence such as the allegations in a complaint.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Business Judgment Rule

HN34[] **Fiduciary Duties, Business Judgment Rule**

The business judgment rule provides corporate directors with a very substantial amount of deference, but not an unlimited amount.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Business Judgment Rule

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Good Faith

HN35[] **Fiduciary Duties, Business Judgment Rule**

The business judgment rule does not apply in circumstances which inherently raise an inference of conflict of interest nor to actions taken with improper motives, or as a result of a conflict of interest. When self-dealing is involved the transaction will be scrutinized for fairness. Any transaction between the corporation and a director or a dominant or controlling stockholder, or group of stockholders, is subject to the following test: their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein. The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain. If it does not, equity will set it aside.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Business Judgment Rule

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Good Faith

HN36[] **Fiduciary Duties, Business Judgment Rule**

The Delaware Supreme Court scrutinizes self-dealing transactions under the entire fairness standard, which it has described as follows: the concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the transaction, including all relevant factors. However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Good Faith

HN37[] **Fiduciary Duties, Duty of Good Faith**

See *Cal. Corp. Code § 310(a)*.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Business

Judgment Rule

HN38[] Fiduciary Duties, Business Judgment Rule

In California, the business judgment rule apparently does not protect officers. See *Cal. Corp. Code § 309(a)-(c)*.

Business & Corporate Compliance > ... > Business & Corporate Law > Corporations > Articles of Incorporation & Bylaws

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Care

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Good Faith

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Loyalty

HN39[] Corporations, Articles of Incorporation & Bylaws

A corporation's governing documents generally can excuse directors from the duty of care but not the duty of loyalty or good faith. That is particularly significant for Caremark duties because those have been held to be part of the duty of good faith so, at least in Delaware, exculpatory provisions cannot exonerate directors for violations of their Caremark duties. That is hardly surprising: the whole point of having a board of directors is to oversee the corporation, so it would make no sense to permit them to be exculpated in advance for completely failing to oversee the corporation -- i.e., if they have utterly failed to implement any reporting or information system or controls or have consciously failed to monitor or oversee such a system or controls, thus disabling themselves from being informed of risks or problems requiring their attention. This United States Bankruptcy Court for the Central District of California anticipates that the California Supreme Court would reach the same conclusion: directors cannot be exculpated in the articles of incorporation from breaches of their Caremark duties.

Business & Corporate Compliance > ... > Business & Corporate Law > Corporations > Articles of Incorporation & Bylaws

HN40[] Corporations, Articles of Incorporation & Bylaws

See *Cal. Corp. Code § 204(a)(10)*.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Care

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Good Faith

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Loyalty

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty to Third Parties

HN41[] Fiduciary Duties, Duty of Care

What principally changes upon insolvency is who can sue for breaches of fiduciary duties. Normally the fiduciary duties of care, loyalty, and good faith run not only to stockholders but also to the corporation itself, under *Cal. Corp. Code § 309*, and decisions under that law, as well as analogous decisions from Delaware and other jurisdictions.

Business & Corporate Compliance > ... > Business & Corporate Law > Corporations > Articles of Incorporation & Bylaws

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Care

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Good Faith

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Loyalty

HN42[] Corporations, Articles of Incorporation &

Bylaws

A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances. *Cal. Corp. Code § 309(a)*. Likewise, *Cal. Corp. Code § 204(a)(10)* provides that directors cannot be exculpated for breaching certain fiduciary duties to the corporation or its shareholders.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Good Faith

HN43[] **Fiduciary Duties, Duty of Good Faith**

In California, corporate directors owe a fiduciary duty to the corporation and its shareholders and as set out by statute, must serve in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders. *Cal. Corp. Code § 309(a)*.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty to Third Parties

HN44[] **Fiduciary Duties, Duty to Third Parties**

In California and elsewhere, all of the assets of a corporation, immediately on its becoming insolvent, become a trust fund for the benefit of all of its creditors.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty to Third Parties

HN45[] **Fiduciary Duties, Duty to Third Parties**

The scope of any extracontractual duty owed by corporate directors to an insolvent corporation's creditors is limited in California, consistent with the trust fund doctrine, to the avoidance of actions that divert, dissipate, or unduly risk corporate assets that might otherwise be used to pay creditors' claims.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty to Third Parties

HN46[] **Fiduciary Duties, Duty to Third Parties**

In Berg, the Court of Appeal of California observed that generally, any recovery for breaching the fiduciary duties imposed under the trust fund doctrine in California involved cases where the directors or officers of an insolvent corporation have diverted assets of the corporation for the benefit of insiders or preferred creditors. It interpreted California law not to create any paramount fiduciary duty of due care or loyalty that directors of an insolvent corporation owe the corporation's creditors, nor any duty in an amorphous zone or vicinity of insolvency. Berg rejected the seminal Credit Lyonnais decision of the Delaware Court of Chancery to the extent it can be read to imply otherwise.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty to Third Parties

HN47[] **Fiduciary Duties, Duty to Third Parties**

In Berg, the Court of Appeal of California held that under California law, the duty to creditors only arises upon insolvency and is limited to the avoidance of actions that divert, dissipate, or unduly risk corporate assets that might otherwise be used to pay creditors' claims. When insolvency arises, the risk bearers include creditors, and the value of creditors' contract claims can be directly jeopardized by management's business decisions. What Berg appears to mean by avoiding actions that "unduly risk" corporate assets is that directors must attempt to avoid asset depletion and instead maximize the corporation's long term wealth creating capacity. That is consistent with authority from the Delaware Supreme Court that directors have a duty to attempt to maximize the value of the insolvent corporation for the benefit of all those having an interest in it.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Business Judgment Rule

Business & Corporate Law > ... > Management

Duties & Liabilities > Fiduciary Duties > Duty to Third Parties

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Good Faith

HN48[] Fiduciary Duties, Business Judgment Rule

The duty that arises upon a corporation's insolvency is essentially, if not exactly, the same as the overall duty to stockholders and the corporation outside of insolvency: to exercise business judgment in an informed and good faith effort to preserve and grow the corporation's value. What changes upon insolvency is the constituency: the creditors are now "risk bearers" so they now have the right, like stockholders, to bring a derivative action in the corporation's name against directors who unduly risk corporate assets.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Business Judgment Rule

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty to Third Parties

HN49[] Fiduciary Duties, Business Judgment Rule

Under California law, no new duties are triggered by a corporation's insolvency. Directors' duty remains essentially if not entirely unchanged: to attempt to preserve and grow corporate value. This interpretation is also consistent with the trend in decisions in Delaware (and other states). Under Delaware law, fiduciary duties of directors and officers of financially troubled companies run to the corporation itself, and not to the unique constituencies interested in the corporation. Coupled with the protection afforded by the business judgment rule, Delaware law affords managers of troubled companies a broad discretion to act in the long-term interests of the corporation without worry that their actions will draw fire from either shareholders or creditors. The creditors of an insolvent firm have no greater right to challenge a disinterested, good faith business decision than the stockholders of a solvent firm.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty to Third Parties

HN50[] Fiduciary Duties, Duty to Third Parties

Stockholders and creditors are likely to have different approaches to risk, especially upon insolvency. Creditors, holding fixed claims, generally prefer corporate decisions that minimize the risk of failure, whereas stockholders generally prefer risky strategies because they profit from the success of those decisions but share the losses with creditors if the decisions fail. If directors acted solely at the direction of creditors they might take on too little risk, from the standpoint of maximizing the corporation's long-term wealth creating capacity. Conversely if they acted solely at the direction of stockholders they might take on too much risk.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Business Judgment Rule

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Good Faith

HN51[] Fiduciary Duties, Business Judgment Rule

When faced with conflicting constituencies, directors are protected by the business judgment rule if they attempt in good faith to follow their overall duty to attempt to preserve and enhance corporate profitability or value.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Business Judgment Rule

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty to Third Parties

HN52[] Fiduciary Duties, Business Judgment Rule

Corporate directors have enormous discretion in exercising their business judgment to weigh the alternative courses of action, within the broad mandate to attempt to preserve and enhance corporate profitability/value. That includes not only how to enhance profitability/value but also on what time frame -- short term or long term -- because directors can chart a course for a corporation which is in its best interests without regard to a fixed investment horizon. Corporate directors do not have a duty to shut down the insolvent firm and marshal its assets for distribution to creditors, although they may make a business judgment that this is indeed the best route to maximize the firm's value. Conversely, even when a firm is insolvent, its directors may, in the appropriate exercise of their business judgment, take action that might, if it does not pan out, result in the firm being painted in a deeper hue of red. The fact that the residual claimants of the firm at that time are creditors does not mean that the directors cannot choose to continue the firm's operations in the hope that they can expand the inadequate pie. Within the broad scope of their exercise of business judgment, directors are protected from liability if these decisions are second guessed by either creditors or stockholders.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty to Third Parties

HN53[] Fiduciary Duties, Duty to Third Parties

As the Ninth Circuit has observed in attempting to define insolvency in an analogous context, when there is little legislative guidance it is appropriate to consider underlying policies of the law. The most relevant underlying policy is for directors to avoid actions that unduly risk corporate assets that might otherwise be used to pay creditors' claims. Guided by this policy, if a corporation is in recognizable financial distress then its actions should be dictated by that financial reality, regardless how that distress is manifested. After all, that is why the different tests of insolvency evolved.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty to Third Parties

HN54[] Fiduciary Duties, Duty to Third Parties

It seems likely that the California Supreme Court, if faced with the issue, would hold that all three tests of insolvency apply for purposes of bringing claims for breach of fiduciary duties on a creditor's behalf: balance sheet, cash flow, and inadequate capitalization.

Business & Corporate Law > ... > Directors & Officers > Management Duties & Liabilities > Fiduciary Duties

HN55[] Management Duties & Liabilities, Fiduciary Duties

Corporate officers owe fiduciary duties that are identical to those owed by corporate directors.

Bankruptcy Law > ... > Avoidance > Fraudulent Transfers > Constructively Fraudulent Transfers

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty to Third Parties

Civil Procedure > Judgments > Enforcement & Execution > Fraudulent Transfers

Bankruptcy Law > ... > Preferential Transfers > Elements > Debtor Insolvency

HN56[] Fraudulent Transfers, Constructively Fraudulent Transfers

Insolvency by any measure is sufficient for purposes of bringing derivative breach of fiduciary duty claims on creditors' behalf. In addition, insolvency by any measure is sufficient for purposes of one or another of the Bankruptcy Code and California avoidance statutes.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Care

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Good Faith

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Loyalty

HN57[] Fiduciary Duties, Duty of Care

Directors have duties (both upon insolvency and at all times) of care, loyalty and good faith, all in service of the ultimate duty not to divert, dissipate, or unduly risk corporate assets.

Civil Procedure > ... > Defenses, Demurrers & Objections > Motions to Dismiss > Failure to State Claim

HN58[] **Motions to Dismiss, Failure to State Claim**

To be entitled to presumption of truth, allegations in a complaint (1) must not simply recite elements of claim but must contain sufficient allegations of underlying facts to give fair notice and enable opposing party to defend itself effectively, and (2) must plausibly suggest an entitlement to relief, such that it is not unfair to require the opposing party to be subjected to the expense of discovery and continued litigation.

Torts > Negligence > Gross Negligence

HN59[] **Negligence, Gross Negligence**

Gross negligence requires a showing of failure to exercise even slight care.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Business Judgment Rule

Civil Procedure > ... > Responses > Defenses, Demurrers & Objections > Affirmative Defenses

Civil Procedure > ... > Defenses, Demurrers & Objections > Motions to Dismiss > Failure to State Claim

HN60[] **Fiduciary Duties, Business Judgment Rule**

The business judgment rule is a fact bound affirmative defense which provides no basis for dismissal under *Fed. R. Civ. P. 12(b)(6)*.

Business & Corporate Law > ... > Directors & Officers > Management Duties & Liabilities > Fiduciary Duties

HN61[] **Management Duties & Liabilities, Fiduciary Duties**

Under California law, an independent, outside, and disinterested director will not be held to any sophisticated business standard but instead to the standard of an ordinary prudent person.

Business & Corporate Law > ... > Directors & Officers > Management Duties & Liabilities > Fiduciary Duties

HN62[] **Management Duties & Liabilities, Fiduciary Duties**

When directors and officers have engaged in similar conduct, alleging claims as to the whole group of similarly situated directors and officers is sufficient.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty to Third Parties

Business & Corporate Law > ... > Management Duties & Liabilities > Defenses > Ratification

HN63[] **Fiduciary Duties, Duty to Third Parties**

Stockholder ratification does not apply to any claims of breaches of fiduciary duty while a debtor was insolvent.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty to Third Parties

Business & Corporate Law > ... > Management Duties & Liabilities > Defenses > Ratification

HN64[] **Fiduciary Duties, Duty to Third Parties**

When a corporation is insolvent, the trust fund doctrine fundamentally alters the relationship between a corporation, its shareholders and its creditors, and corporate or shareholder ratification does not apply to creditors who would be prejudiced thereby.

Business & Corporate Law > ... > Shareholder Duties & Liabilities > Controlling Shareholders > Causes of Action

Evidence > Burdens of Proof > Allocation

HN65[] **Controlling Shareholders, Causes of Action**

Claims of corporate waste in California are based upon Delaware state law. To recover on a claim of corporate waste, plaintiffs must shoulder the burden of proving that the exchange was so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration.

Bankruptcy Law > ... > Types of Claims > Unsecured Priority Claims > Subordination

HN66[] **Unsecured Priority Claims, Subordination**

In the Ninth Circuit, a plaintiff must sufficiently allege three elements in order to state a claim for equitable subordination: (1) that the claimant who is to be subordinated has engaged in inequitable conduct; (2) the misconduct results in injury to competing claimants or an unfair advantage to the claimant to be subordinated; and (3) subordination is not inconsistent with bankruptcy law.

Bankruptcy Law > ... > Types of Claims > Unsecured Priority Claims > Subordination

Evidence > Burdens of Proof > Allocation

HN67[] **Unsecured Priority Claims, Subordination**

The burden of establishing equitable subordination is very heavy. For example, even aiding and abetting fraud does not necessarily establish grounds for equitable subordination. On the other hand, a wide range of inequitable conduct can, depending on the particular facts and circumstances, support a claim of equitable subordination. The issue is highly dependent on the specific facts presented. In addition, when a complaint seeks to subordinate a claim arising from the dealings between a debtor and an insider, a court will give the insider's actions rigorous scrutiny.

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Judges: Neil W. Bason, United States Bankruptcy Judge.

Opinion by: Neil W. Bason

Opinion

[*305] OPINION ON DIRECTORS' AND OFFICERS' DUTIES UPON INSOLVENCY, AND RELATED ISSUES

I. INTRODUCTION[1]

The individual defendants were all directors of the debtor corporation, then known as Rhythm & Hues, Inc. ("Debtor"), before it filed its bankruptcy petition on February 13, 2013 (the "Petition Date"). Some defendants also served as Debtor's officers. The plaintiff, which is the liquidating trustee under Debtor's confirmed chapter 11 plan, alleges that while Debtor was insolvent these defendants (the "Directors") diverted its assets to themselves, or dissipated or unduly risked those assets. The plaintiff seeks to recover damages for the benefit of Debtor's creditors.

The Directors argue that there is no duty to creditors even upon insolvency — that their duties run solely to stockholders — and alternatively that the plaintiff has not adequately alleged insolvency. This opinion rejects those arguments. In so doing this opinion interprets what measures of insolvency apply and what it means for directors **[**4]** (and officers) to "unduly risk" a corporation's assets under the leading California decisions.

Some issues of California law are not settled, so this opinion must predict how the Supreme Court of California would interpret directors' and officers' duties. The prediction is that it would do so consistent with what appears to be the emerging trend in other Federal and State court decisions.

Specifically, the most relevant duty of directors and officers remains the same regardless of insolvency: the duty to exercise their business judgment in an informed, good faith effort to preserve and grow the corporation's value. That duty must be exercised for the benefit of the whole corporate enterprise, encompassing all of its constituent groups, without undue preference to any. What principally changes upon insolvency is who can sue. For acts or omissions occurring outside of insolvency, the creditors cannot sue because they have no cognizable harm. But when the corporation is insolvent or is rendered insolvent by any standard measure — balance sheet, cash flow, or inadequate capitalization — then creditors join **[*306]** stockholders in being able to sue derivatively for breaches of fiduciary duties to **[**5]** the corporation that divert, dissipate, or unduly risk corporate assets.

As a practical matter, the alternative to such essentially unchanging duties would be for directors' and officers' duties to change substantially once the corporation crossed some invisible line that is later determined to constitute insolvency. Such a rule would be unfair to directors and officers, and it would harm all constituent groups by creating conflicting incentives and unclear directions for risk management. This Bankruptcy Court does not anticipate that the California Supreme Court would interpret directors' and officers' duties in that way.

This opinion also rejects most of the other arguments in the defendants' motions to dismiss or for a more definite statement, including most of their assertions that the plaintiff's claims are barred as a matter of law by the business judgment rule. That is not to say that the business judgment rule lacks teeth; to the contrary it is a very powerful defense, but on the facts alleged in the complaint it is not possible to conclude as a matter of law that it applies. In addition, the defendants have established some statute of limitation defenses.

II. BACKGROUND

[1] For brevity, filed documents are referred to by docket number rather than their full title ("dkt. __" for documents filed in this Adversary Proceeding, No. 2:15-ap-01095-NB, or "Case dkt. __" for documents filed in the main case, No. 2:13-bk-13775-NB). Many arguments are repeated in numerous briefs, and this opinion will not always refer to every location where the argument was made. Unless the context suggests otherwise, references **[**3]** to a "chapter" or "section" ("§") refer to the United States Bankruptcy Code, ***11 U.S.C. § 101 et seq.*** (the "Bankruptcy Code"), and other terms have the meanings provided in the Bankruptcy Code, the Rules, and the parties' briefs. This opinion supersedes the memorandum decision on the same issues (dkt. 101).

A. Factual [6] Allegations**

Debtor was one of the premiere producers of visual effects and computer-generated animation for the entertainment industry. It blames its financial troubles on a variety of factors, including thin margins, projects that have inherently unpredictable costs, and international competition. *See, e.g.*, Case dkt. 9. The plaintiff, however, places much of the blame on alleged self-dealing, fraudulent transfers, and other asserted acts and omissions by Debtor's Directors.

The complaint defines the "Primary" Directors as John Patrick Hughes (a director, president, treasurer, and, at times, its chief financial officer), his wife Pauline Ts'O (also a director and officer), and Keith Goldfarb (a director). The "Other" Directors are Lee Berger (a director and officer), Prashant Buyyala (same), Raymond Feeney (a director), and David Weinberg (a director and, at relevant times, chief financial officer or "CFO"). Complaint (dkt. 1) ¶¶ 7-15.

The following summary includes some pejorative descriptions of the Directors' alleged acts and omissions because, as always ***HN1***[] in the context of motions to dismiss, all well pled and plausible allegations are assumed to be true, and all reasonable inferences **[**7]** are drawn in the non-moving party's favor. *Ashcroft v. Iqbal, 556 U.S. 662, 678, 129 S. Ct. 1937, 173 L. Ed. 2d 868 (2009)*. The facts might (or might not) turn out to be very different after discovery or after trial.

1. The CCCD Transactions: risky, self-dealing advances, mostly without board approval; and then $1 buyout by Hughes after the gamble paid off

From July 2007 through December 2009 the Primary Directors used $1.89 million of Debtor's scarce capital to fund CCC Diagnostics, LLC ("CCCD"), which was founded by Ts'O's father (Hughes' father-in-law). CCCD had no revenues, was in a business "wholly unrelated" to Debtor's line of business, and "had absolutely no corporate synergies" with Debtor. Complaint (dkt. 1) ¶ 30. In exchange for these investments (the "CCCD Transfers") Debtor received five unsecured convertible promissory notes, all of which lacked "performance milestones," "adjustments to the conversion ratio based upon performance," and "other financial requirements" which **[*307]** "would have been typical of an investment in a start-up venture." *Id. ¶¶ 30-42*.

Hughes was on both sides: he negotiated the notes on behalf of both Debtor and CCCD. Before the fifth investment, 100% of the membership interest in CCCD was transferred to a newly formed entity, CCC Diagnostics, **[**8]** Inc. ("CCCD, Inc."), of which Hughes was President, a board member, and a stockholder. Weinberg (Debtor's CFO and a board member) pointed out Hughes' conflicts of interest in email correspondence. Nevertheless, only the first of the CCCD notes was approved or ratified by Debtor's board. *Id.*

Eventually the gamble paid off; but not for Debtor. CCCD was able to commercialize its product and, in a private placement memorandum dated August 2012, Hughes and other officers of CCCD valued that company at $10 million. Just a few months later, though, in November 2012, Hughes arranged to purchase the entire $1.89 million series of convertible notes for $1. "Given that these notes were convertible into an 18.9% membership interest, this $1.00 purchase price equated to a $5.29 valuation for CCCD." *Id. ¶ 44*. This sale (the "CCCD Note Sale") was not approved or ratified by Debtor's board, nor was it accompanied by any fairness opinion or determination.

In addition, the complaint alleges, the Primary Directors caused Debtor to provide services to CCCD at no charge, and Hughes attempted to divert investors from Debtor to CCCD. The remaining Directors allegedly knew or should have known of these things **[**9]** and did nothing to stop them. *Id. ¶¶ 46-48*.

2. The RHM Software Rights Transfer: giving key software rights to the Primary Directors' overseas corporation for no consideration

On November 1, 2008, the Primary Directors caused Debtor to enter into a Memorandum of Understanding ("MOU") for computer graphic and animation services with a Malaysian business known as Rhythm & Hues Sdn. Bhd (the "RHM"). The Primary Directors owned RHM, and they were on both sides of the transaction. The MOU was executed by Buyyala on behalf of Debtor and Hughes on behalf of RHM. Complaint (dkt. 1) ¶¶ 49-50.

RHM filed a proof of claim in the underlying bankruptcy, attaching a copy of the MOU that, unlike the copy in Debtor's files, included an "Addendum B" which purports to transfer to RHM in perpetuity all of Debtor's rights in certain software "which had been developed over decades and used to win multiple awards in the film industry." *Id. ¶ 54*. Hughes testified that this addendum was created in late 2012, shortly before the Petition Date. RHM now employs many of Debtor's former employees, including Hughes. *Id. ¶¶ 51-53*.

Debtor received no consideration for this software transfer (the "RHM Software Rights Transfer"). **[**10]** It was not approved or ratified by Debtor's board of directors. *Id. ¶ 52*.

3. The 2100 Grand Transaction: non-recourse advances to the Primary Directors to buy the business premises, then leasing back the premises at full market rates — leaving Debtor with all of the risks and none of the upside

In early 2009 the Primary Directors caused Debtor to advance millions of dollars to them, on a non-recourse basis, without taking back any of their assets as collateral, and at a 4% interest rate, to buy a six-story office building located at 2100 East Grand Avenue, El Segundo, California, through an entity they created and owned, known as 2100 Grand LLC ("2100 Grand"). Debtor then leased back the **[*308]** property at full market rates, at a cost of $264,000 per month. In December of 2010, due to breaches in the Primary Directors' financial covenants caused by the fifth CCCD note, they had to refinance the 2100 Grand mortgage, and once again Debtor advanced the funds to do so, on similar terms. These transactions (collectively, the "2100 Grand Transaction") shifted all of the upside to the Primary Directors, while leaving Debtor with all risks of the purchase and draining it of $14 million of scarce capital, **[**11]** of which it eventually lost nearly $9.4 million. The Other Directors allegedly knew about this transaction but did nothing to stop it, reasonably inform themselves about it, or seek a fairness opinion. Complaint (dkt. 1) ¶¶ 55-63.

4. Operational Issues: unfavorable studio contracts, cost-cutting failures, etc.

The complaint alleges that the Directors recklessly caused Debtor to become increasingly dependent on just three studios, underbid and forgo potential profits, engage in low profit margin and high risk work, neglect profitable ventures, engage in ill-informed and flawed bidding practices, fail to negotiate for key protections such as reimbursement in the event that the studio delayed or stopped projects, fail to monitor and obtain payment for change orders that were not Debtor's fault, incur massive payroll liabilities, refuse to cut excessive costs, establish wasteful benefit policies that resulted in enormous accrued liabilities for paid time off and sabbaticals, and permit certain executives including Weinberg to resign and cash out those benefits and immediately be re-hired as consultants (collectively, the "Reckless Operational Acts" and, as to Weinberg, the "Weinberg PTO **[**12]** Payments"). The complaint alleges that, to the extent the Other Directors were not personally involved in these matters, they knew or should have known about them but did nothing to stop them and, "[m]anifesting a consistent pattern of inattentiveness, the Other [Directors] relinquished their role as [Debtor's] officers and/or directors and ignored these problems." *Id. ¶¶ 64-73*.

5. Loss of tax benefits: net operating losses

The Primary Directors and Weinberg elected to carry forward, rather than back, Debtor's 2010 net operating losses ("NOLs"), thereby sacrificing certain and substantial tax refunds for 2008 and 2009 in exchange for speculative and insubstantial future tax offsets for 2011 and 2012, at a cost of well over $900,000 (the "Loss of NOLs"). *Id. ¶¶ 75 & 79*. The complaint alleges that companies "never" make such an election "when they have enough prior income to fully utilize the NOL," yet this is "precisely" what the Primary Directors and Weinberg did. *Id. ¶ 75*. "When Hughes was asked under oath about this valuable NOL, which might have provided a lifeline to [Debtor], he explained that issues like this were never presented to him, and that no board meeting addressed this issue." *Id. ¶ 76* **[**13]** . The complaint alleges that "Weinberg displayed a reckless disregard for his duties," the "Primary [Directors] knew or should have known of the Loss of NOLs and the harm that could be done to [Debtor]," and the Other Directors, "following their pattern of inattentiveness, either failed to inform themselves of the issue or act to prevent the Loss of NOLs." *Id. ¶ 80*.

B. Procedural History

On February 13, 2015, the plaintiff filed the complaint on behalf of Debtor's liquidating trust. A plan of reorganization (Case dkt. 352) confirmed by this court (Case dkt. 488) expressly reserves all causes of action belonging to Debtor **[*309]** and/or its bankruptcy estate for post-confirmation enforcement by the trust. According to the complaint, the Directors' conduct caused the destruction of over $70 million of Debtor's value, which the plaintiff seeks to recover from the Directors or D&O insurance.

The defendants have each filed motions to dismiss, or in some instances for a more definite statement (dkt. 36, 37, 41, 42, 43, 50). The plaintiff filed its consolidated opposition (dkt. 57), the defendants filed replies (dkt. 61-66), and some supplemental papers were filed (dkt. 97, 98). The matter was heard **[**14]** on September 1, 2015 and, briefly, on October 6, 2015 and February 23, 2016.

The complaint's 32 separate counts fall into three broad categories: (1) alleged breaches of fiduciary duties or similar claims (including aiding and abetting, corporate waste, and unjust enrichment) (Counts 1-5, 22, 23), (2) alleged avoidable transfers (fraudulent transfers under both federal and California law, and a preferential transfer under *§ 547*) (Counts 6-21), and (3) objections to claims (including equitable subordination) (Counts 24-32). The defendants principally argue that (1) they owed no duties to creditors, even when Debtor was insolvent (*e.g.*, dkt. 37, pp. 16:1-19:9); (2) the complaint does not adequately plead insolvency (*e.g.*, dkt. 37, pp. 23:14-24:15; dkt. 42,. pp. 6:21-8:3; dkt. 50, pp. 6:21-8:3); (3) they are protected by the business judgment rule or stockholder ratification (*e.g.*, dkt. 42, pp. 5:3-6:20; dkt. 50, pp. 5:3-6:20); and (4) certain transactions, particularly some of the 2100 Grand note transactions, did not occur within the applicable statute of limitations (*e.g.*, dkt. 42, pp. 13:5-14:11; dkt. 50, pp. 13:5-14:11).

III. JURISDICTION AND AUTHORITY

For the reasons set forth in a concurrently **[**15]** issued opinion, this Bankruptcy Court concludes that it has subject matter jurisdiction over all the claims, and has the authority to issue final judgments or orders on pretrial matters that do not involve factual findings, such as the present motions. To the extent that this Bankruptcy Court does not have the authority to issue a final judgment or order, the discussion below should be deemed to be proposed findings of fact and conclusions of law for *de novo* review by an Article III Court.

IV. LEGAL STANDARDS

A. Motion to Dismiss

HN2[] A motion to dismiss for failure to state a claim upon which relief can be granted is governed by *Rule 12(b)(6)* (incorporated by *Rule 7012(b)*). *Rule 8(a)(2)* (incorporated by *Rule 7008*), requires the plaintiff to provide a "short and plain statement of the claim showing that the pleader is entitled to relief, in order to give the defendant fair notice of what the claim is and the grounds upon which it rests." *Bell Atl. Corp. v. Twombly, 550 U.S. 544, 555, 127 S. Ct. 1955, 167 L. Ed. 2d 929 (2007)* (citations and internal quotation marks omitted). The standards under these rules are well known to the parties, and need only be summarized here. *See generally* Motions to Dismiss (dkt. 36, pp. 3:21-4:16; dkt. 37, pp. 7:4-9:10; dkt. 42, pp. 3:12-4:11; dkt. 43, pp. 6:10-7:15; dkt. 50, pp. 3:11-4:11); **[**16]** Opposition (dkt. 57, pp. 2:9-3:13).

HN3[] "To survive a motion to dismiss, a complaint must contain sufficient factual matter, accepted as true, to 'state a claim to relief that is plausible on its face.'" *Ashcroft v. Iqbal, 556 U.S. 662, 678, 129 S. Ct. 1937, 173 L. Ed. 2d 868 (2009)* (quoting *Twombly, 550 U.S. 544, 570, 127 S. Ct. 1955, 167 L. Ed. 2d 929)*. "A claim has facial plausibility when the plaintiff pleads factual content that allows the court to draw the reasonable **[*310]** inference that the defendant is liable for the misconduct alleged." *Iqbal, 556 U.S. 662, 678, 129 S. Ct. 1937, 173 L. Ed. 2d 868* (citation omitted). "While a complaint attacked by a *Rule 12(b)(6)* motion to dismiss does not need detailed factual allegations, . . . a plaintiff's obligation to provide the 'grounds' of his 'entitlement to relief' requires more than labels and conclusions, and a formulaic recitation of a cause of action's elements will not do." *Twombly, 550 U.S. 544, 546, 127 S. Ct. 1955, 167 L. Ed. 2d 929*. "Determining whether a complaint states a plausible claim for relief is a context-specific task that requires the reviewing court to draw on its judicial experience and common sense." *In re JMC Telecom, LLC, 416 B.R. 738, 742 (C.D. Cal. 2009)* (citation omitted).

Stated otherwise, ***HN4***[] a motion to dismiss "under *Rule 12(b)(6)* challenges the legal sufficiency of a complaint, considered with the assumption that the facts alleged are true." *Francis v. Giacomelli, 588 F.3d 186, 192 (4th Cir. 2009)* (emphasis added, citations omitted). Thus, "dismissal for failure to state a claim is proper only where there is no **[**17]** cognizable legal theory or an absence of sufficient facts alleged to support a cognizable legal theory." *Shroyer v. New Cingular Wireless Servs., Inc., 622 F.3d 1035, 1041 (9th Cir. 2010)* (citation omitted).

HN5[] The Ninth Circuit has recently summarized this standard:

> In sum, for a complaint to survive a motion to dismiss, the non-conclusory "factual content," and reasonable inferences from that content, must be plausibly suggestive of a claim entitling the plaintiff to relief. [Moss v. U.S. Secret Serv., 572 F.3d 962, 969 (9th Cir. 2009) (citation omitted)].

Rule 9(b) adds an additional requirement. HN6[] A party alleging fraud must "state with particularity" the circumstances constituting fraud. The paragraphs of the complaint that appear to sound in fraud are those alleging transfers in actual fraud of creditors (as opposed to constructively fraudulent transfers) and those alleging actual intent by the Primary Directors to transfer assets to themselves at the expense of Debtor and its creditors. As to those claims Rule 9(b) applies, but it does not apply to the remaining claims, such as alleged reckless breaches of fiduciary duties or alleged failure over oversight by the Other Directors. *See* Am. Apparel, Inc. Shareholder Deriv. Litig., 2012 U.S. Dist. Lexis 146970 at *38-39 (C.D. Cal.) (Rule 9(b) did not apply to claims for breach of fiduciary duty because those claims did not sound in fraud). *See* dkt. 97, 98.

HN7[] Rule 9(b) requires that the "circumstances constituting **[**18]** the alleged fraud be specific enough to give defendants notice of the particular misconduct so that they can defend against the charge and not just deny that they have done anything wrong." Vess v. Ciba-Geigy Corp. USA, 317 F.3d 1097, 1106 (9th Cir. 2003) (citation and internal quotation marks omitted). The rule is satisfied if the complaint identifies the "who, what, when, where, and how" of the alleged misconduct. *Id.* (same)

B. Motion for a More Definite Statement

HN8[] "A party may move for a more definite statement of a pleading to which a responsive pleading is allowed but which is so vague or ambiguous that the party cannot reasonably prepare a response." Rule 12(e) (incorporated by Rule 7012(b)). But when the issues involve "highly fact-sensitive inquiry, the better practice is to resolve [the issues] on summary judgment, after full discovery[,]" rather than attempting to do so on a motion for a more definite statement. One Indus., LLC v. **[*311]** Jim O'Neal Distrib., Inc., 578 F.3d 1154, 1160 (9th Cir. 2009).

V. DISCUSSION

A. Governing Law

The parties' chief disputes involve insolvency and fiduciary duties. Different laws apply to each.

HN9[] Insolvency is defined by the Bankruptcy Code for purposes of federal avoidance claims under §§ 547 and 548. Insolvency is defined by California law for purposes of State avoidance claims incorporated by § 544. There is no statutory definition **[**19]** of insolvency for purposes of the fiduciary duty claims.

Corporate fiduciary duties are governed by California law, because Debtor was organized under California law. Complaint (dkt. 1) ¶ 20. California courts often look to decisions from Delaware and other States. *See, e.g.,* Swingless Golf Club Corp. v. Taylor, 679 F.Supp.2d 1060, 1070 (N.D. Cal. 2009) ("Claims of corporate waste in California are based upon Delaware state law."); Oakland Raiders v. Nat'l Football League, 93 Cal.App.4th 572, 586, 113 Cal. Rptr. 2d 255 (Cal. Ct. App. 2001), *as modified on denial of reh'g* (reviewing both Delaware and Maryland decisions regarding stockholder demands). *See also* Tr. 9/01/15 (dkt. 83, p. 20:17-18) (defendants' counsel: "We are embracing Delaware in this case.").

HN10[] When the California Supreme Court has not decided a state law issue, the federal courts must predict how it would decide the issue by looking to other sources, such as "intermediate appellate court decisions, decisions from other jurisdictions, statutes, treatises, and restatements." Vestar Development II v. General Dynamics Corp., 249 F. 3d 958, 960 (9th Cir. 2001) (citation and internal quotation marks omitted). When there is "relevant precedent from the state's intermediate appellate court, the federal court must follow [that precedent] unless the federal court finds convincing evidence that the state's supreme court likely would not follow it." Ryman v. Sears, Roebuck & Co., 505 F.3d 993, 994 (9th Cir. 2007).

B. The Avoidance Statutes, And Their Definitions [**20] Of Insolvency

HN11[] Section 548(a) provides in relevant part:

(1) The trustee may avoid any transfer ... of an

interest of the debtor in property, or any obligation ... incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily —

(A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or

(B)(i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and

(ii) (I) [balance sheet insolvency] was insolvent on the date that such transfer was made or obligation was incurred [meaning that the debtor had a "financial condition such that the sum of [its] debts is greater than all of [its] property, at a fair valuation, exclusive of ... property transferred, concealed, or removed with intent to hinder, delay, or defraud [its] creditors ..." (*§ 101(32)*)], or became insolvent [under the same definition] as a result of such transfer or obligation;

[*312] (II) [inadequate capitalization] was engaged in business or a transaction, **[**21]** or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; [or]

(III) [cash flow or equitable insolvency] intended to incur, or believed that [it] would incur, debts that would be beyond [its] ability to pay as such debts matured.

HN12[] An avoidable preference under *§ 547* includes balance sheet insolvency as one of its elements. *11 U.S.C. § 547(b)(3)*. The relevant California statutes have similar tests of balance sheet insolvency, cash flow insolvency, and inadequate capitalization.[2]

HN13[] *California Civil Code section 3439.04(a)* provides, in relevant part:

(a) A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or **[**22]** incurred the obligation as follows:

(1) With actual intent to hinder, delay, or defraud any creditor of the debtor;

(2) Without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor either:

(A) [inadequate capitalization] Was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction.

(B) [cash flow] Intended to incur, or believed or reasonably should have believed that he or she would incur, debts beyond his or her ability to pay as they became due.

(b) In determining actual intent under paragraph (1) of subdivision (a), consideration may be given, among other factors, to any or all of the following:

* * *

(9) [balance sheet or presumptive cash flow insolvency] Whether the debtor was insolvent [meaning, in relevant part, "if, at fair valuations, the sum of the debtor's debts is greater than all of the debtor's assets," without including property that has been "transferred, concealed, or removed with intent to hinder, delay, or defraud creditors" or was otherwise fraudulently transferred, and with the further caveat that a debtor "who is generally not paying **[**23]** his or her debts as they become due is presumed to be insolvent" (Cal. Civ. C. *§ 3439.02*)] or became insolvent [under the same definition] shortly after the transfer was made or the obligation was incurred.

The last of the avoidance statutes, ***HN14***[] *California Civil Code section 3439.05* provides, in relevant part:

A transfer made or obligation incurred by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made or the obligation was incurred if the debtor made the transfer or incurred the

[2] The California statutes incorporate all three standard tests of insolvency, though in slightly different ways from *§ 548*. California's codification of the Uniform Fraudulent Transfer Act is at *California Civil Code §§ 3439.04(a)(1)*&*(2)* and *3439.05* (the applicable versions of these statutes, quoted below, are the ones in effect prior to 2015 amendments, because those amendments only affect transfers made, or obligations incurred, after Jan. 1, 2016, per *Civ. C. § 3439.14(a)*).

HN15[] The second and third insolvency tests described above — inadequate capital and cash flow/equitable insolvency — may be seen as different iterations of the same test: inability to pay debts either in the reasonably foreseeable future or more immediately. The Third Circuit has observed, "some courts have equated a finding of equitable insolvency [aka cash flow insolvency] with that of unreasonably small capital," but "[w]e believe the better view" is that **[**24]** "unreasonably small capital denotes **[*313]** a financial condition short of equitable insolvency," and "we hold the test for unreasonably small capital is reasonable foreseeability" that lack of capital would lead to an "inability to generate enough cash flow to sustain operations." *Moody v. Security Pacific Business Credit, Inc., 971 F.2d 1056, 1070,1073 (3rd Cir. 1992)* (footnotes omitted).

Insolvency for purposes of the complaint's claims for breach of fiduciary duty will be reviewed after an examination of what those duties are.

C. Corporate Fiduciary Duties

HN16[] Corporate fiduciary duties typically are divided into three categories (although the last of these may be a sub-category):

> Duty of care — This is the duty to exercise reasonable prudence in making business judgments for the corporation, including gathering adequate information and undertaking due consideration of the relevant issues. *See, e.g., Lamden v. La Jolla Shores Clubdominium Homeowners Assn., 21 Cal.4th 249, 258, 87 Cal. Rptr. 2d 237, 980 P.2d 940 (1999)* ("A director shall perform the duties of a director ... with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.").
>
> Duty of loyalty — This is the duty to give primacy to the interest of the corporation, most typically contrasted with acting in self-interest. *See, e.g., Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal.App.2d 405, 419, 241 P.2d 66 (1952)* ("It is a cardinal principle of corporate **[**25]** law that a director cannot, at the expense of the corporation, make an unfair profit from his position. He is precluded from receiving any personal advantage without fullest disclosure to and consent of all those affected.").
>
> Duty of good faith — This duty of good faith is generally considered part of the duty of loyalty, because directors or officers cannot act loyally towards the corporation unless they act in the good faith belief that their actions are in the corporation's best interest, and this has been held to include a duty of oversight. *See Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006)*; *see also Mueller v. Macban, 62 Cal. App. 3d 258, 274, 132 Cal. Rptr. 222 (1976)* ("Directors owe a duty of highest good faith to the corporation and its stockholders, and this same duty is demanded of officers of the corporation.") (citations omitted).

HN17[] It is not entirely clear whether there is any difference between the duties for directors and officers. Delaware decisions have held that these basic duties are the same. *Gantler v. Stephens, 965 A.2d 695, 708 (Del. 2009)* ("[C]orporate officers owe fiduciary duties that are identical to those owed by corporate directors."). For now this discussion focuses on directors.

HN18[] As part of exercising the foregoing duties, directors must monitor for others' wrongdoing. This is often referred to as "*Caremark*" duties. *In re Caremark Int'l Derivative Lit., 698 A.2d 959 (Del. Ch. 1996)*. *See also Stone, 911 A.2d 362, 370* (expressly **[**26]** approving *Caremark* standard).

HN19[] The overall goal, in exercising each of these duties, is to preserve and grow corporate value. *See, e.g., Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140, 1150 (Del. 1990)* (duty to manage corporation attempt to "enhance corporate profitability"); *N. Am. Catholic Educ. Programming Fdn., Inc. v. Gheewalla, 930 A.2d 92, 103 (Del. 2007)* (duty to attempt to "maximize" corporate value).

[*314] HN20[] The elements of a claim for breach of fiduciary duty are (1) the existence of a fiduciary relationship (in this case, a duty to the corporation or to creditors), (2) the breach of that relationship, and (3) damages proximately caused by the breach. *In re GSM Wireless, Inc., 2013 Bankr. Lexis 3298, at *128 (Bankr. C.D. Cal.)*. Remedies include damages for all harm

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obligation without receiving a reasonably equivalent value in exchange for the transfer or obligation and the debtor was insolvent [under the balance sheet test quoted above (Cal. Civ. C. *§ 3439.02*)] at that time or the debtor became insolvent as a result of the transfer or obligation.

proximately caused to the corporation, as well as rescission and restitution. *Id.*

1. The business judgment rule

HN21[] Normally one who breaches a duty through ordinary negligence is liable for the damages that are proximately caused, but directors are protected by the business judgment rule. *Caremark, 698 A.2d 959, 967-68*. That rule is "a judicial policy of deference to the business judgment of corporate directors in the exercise of their broad discretion in making corporate decisions." *Everest Investors 8 v. McNeil Partners, 114 Cal.App.4th 411, 429, 8 Cal. Rptr. 3d 31 (2003)*; *Burt v. Irvine Co., 237 Cal.App.2d 828, 852, 47 Cal. Rptr. 392 (1965)*. *See also Gantler, 965 A.2d 695, 705-06* (business judgment rule is "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the **[**27]** action taken was in the best interests of the company") (citation and quotation marks omitted, emphasis added).

HN22[] The effect of the business judgment rule is to raise the burden of proof from ordinary negligence to gross negligence — "*i.e.*, failure to exercise even slight care." Friedman et al., Cal. Prac. Guide: Corps. (The Rutter Group 2015) Ch. 6-C (citation omitted). *See also Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985)* ("gross negligence" standard applies under Delaware law), *overruled on other grounds by Gantler, 965 A.2d 695*.

Put differently:

> [Corporate directors] will not be held liable for a negligent judgment (*i.e.*, one a reasonably prudent person would not have made) so long as the process leading to the judgment meets business judgment rule requirements. In other words, courts will not "second-guess" the decisions of disinterested directors made with reasonable diligence in ascertaining the facts and believed to be in the corporation's best interests. (This is so even if the directors make a bad or "stupid" decision.) [Cal. Prac. Guide: Corps. (The Rutter Group 2015) Ch. 6-C (emphasis added)]

But the process is critical. *HN23*[] The business judgment rule "presuppose[s] that judgment — reasonable diligence — has in fact been exercised" and "[a] director cannot **[**28]** close his eyes to what is going on about him in the conduct of the business of the corporation and have it said that he is exercising business judgment." *Burt, 237 Cal.App.2d 828, 852-53, 47 Cal. Rptr. 392*. *See also In re Bridgeport Holdings, Inc., 388 B.R. 548, 569 (Bankr. D. Del. 2008)* (holding, under Delaware law, that "if the 'directors individually and the board collectively' fail to inform themselves 'fully and in a deliberate manner,' then they 'lose the protection of the business judgment rule' ....") (citation omitted).[3]

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[3] *HN24*[] The business judgment rule has been partially codified in *California Corporations Code section 309*. That statute at first appears to apply a simple negligence standard, but the parties do not dispute that a gross negligence standard applies under the business judgment rule (apparently because, although directors are required to act under a reasonableness standard, the business judgment rule presumes that they have done so unless that presumption can be overcome by a showing of gross negligence). Cal. Prac. Guide: Corps. (The Rutter Group 2015) Ch. 6-C ("Disinterested directors are *rebuttably presumed* to have acted in good faith (*i.e.*, to have believed their decision was in the corporation's best interests)."); *see Biren v. Equal. Emergency Med. Grp., Inc., 102 Cal.App.4th 125, 136, 125 Cal. Rptr. 2d 325 (2002)* ("A director is not liable for a mistake in business judgment which is made in good faith and in what he **[**29]** or she believes to be the best interests of the corporation[.] The business judgment rule sets up a presumption that directors' decisions are made in good faith[.]") (citations omitted); *see also Katz v. Chevron Corp., 22 Cal.App.4th 1352, 1366, 27 Cal. Rptr. 2d 681 (1994)* ("The business judgment rule is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. ... Under the business judgment rule, director liability is predicated upon concepts of gross negligence.") (citations and punctuation omitted) (applying Delaware law); *Fed. Deposit Ins. Co. v. Faigin, 2013 U.S. Dist. LEXIS 94899, 2013 WL 3389490 at *14 n. 1 (C.D. Cal.)*.

HN25[] *California Corporations Code § 309* provides:

> (a) A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.
>
> (b) In performing the duties of a director, a director shall be entitled to rely on information, opinions, reports or statements, including financial statements and other

[*315] The process that directors must implement is explained in greater detail in *Caremark*. ***HN26***[] Although no reported decision **[**31]** under California corporate law has expressly followed *Caremark*, is has been widely accepted and this Bankruptcy Court knows of no reason why the California Supreme Court would not apply the same reasoning.

> ***HN27***[] [Directors must] assur[e] themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance.
>
> Obviously the level of detail that is appropriate for such an information system is a question of business judgment. And obviously too, no rationally designed information and reporting system will remove the possibility that the corporation will violate laws or regulations, or that senior officers or directors may nevertheless sometimes be misled or otherwise fail reasonably to detect acts material to the corporation's compliance **[*316]** with the law. But it is important that the board exercise a good faith judgment that the corporation's information and reporting system is in concept and design adequate to **[**32]** assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations, so that it may satisfy its responsibility.
>
> Thus, ... ***HN28***[] a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so ... [may] render a director liable for losses caused by non-compliance with applicable legal standards.
>
> * * *
>
> ***HN29***[] Generally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability[-]creating activities within the corporation ... only a sustained or systematic failure of the board to exercise oversight — such as an utter failure to attempt to assure a reasonable information and reporting system exits — will establish the lack of good faith that is a necessary condition to liability.
>
> [*Caremark, 698 A.2d 959, 970-71* (footnote omitted); *see* *Stone, 911 A.2d 362, 369-70* (expressly approving *Caremark* standard).]

2. The Directors appear to over-interpret the exculpatory effect of the business judgment rule

The Directors argue that the complaint is required to, and does not, allege "utter" and "conscious" failures, or "abdications" of duties; **[**33]** and they point to authority that a breach of *Caremark* duties requires more than gross negligence. Dkt. 41, pp. 13:1-15:17; dkt. 42, pp. 9:20-26; dkt. 43, pp. 9:20-26. The Directors are correct that some cases use the words and express those concepts; but the Directors appear to take those words and concepts out of context and read too much into them.

HN30[] *Caremark* articulated directors' duty to attempt "in good faith" to assure the adequacy of information and reporting systems, and the Delaware Supreme Court has held that liability for lack of "oversight" requires a lack of such good faith in that "(a) the directors utterly failed to implement any reporting or information system or controls; *or* (b) having implemented such a system or controls, consciously

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financial **[**30]** data, in each case prepared or presented by any of the following:

(1) One or more officers or employees of the corporation whom the director believes to be reliable and competent in the matters presented.

(2) Counsel, independent accountants or other persons as to matters which the director believes to be within such person's professional or expert competence.

(3) A committee of the board upon which the director does not serve, as to matters within its designated authority, which committee the director believes to merit confidence, so long as, in any such case, the director acts in good faith, after reasonable inquiry when the need therefor is indicated by the circumstances and without knowledge that would cause such reliance to be unwarranted.

(c) A person who performs the duties of a director in accordance with subdivisions (a) and (b) shall have no liability based upon any alleged failure to discharge the person's obligations as a director. In addition, the liability of a director for monetary damages may be eliminated or limited in a corporation's articles to the extent provided in paragraph (10) of *subdivision (a) of Section 204*.

failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention." Stone, 911 A.2d 362, 370 (italics in original, underlining added). The Delaware Supreme Court has also described *Caremark* as addressing situations in which the fiduciary "intentionally fails to act in the face of a known duty to act [*i.e.*, the duty to attempt to establish adequate information and reporting systems], demonstrating **[**34]** a conscious disregard for his duties" which is "qualitatively different from, and more culpable than, the conduct giving rise to a violation of the fiduciary duty of care (*i.e.*, gross negligence)." Stone, 911 A.2d 362, 369 (citation omitted, footnote omitted). Similarly, *Berg* states that the "business judgment rule does not immunize directors for abdication of duty by closing their eyes to what is going on in the conduct of the business." *See* Berg & Berg Enterprises, LLC v. Boyle, 178 Cal.App.4th 1020, 1047, 100 Cal. Rptr. 3d 875 (2009) (emphasis added) (citation omitted).

The emphasized words do not change the Caremark standards.

[*317] a. If directors do not attempt in good faith to establish a system that is reasonably designed to provide timely, accurate, and sufficient information, then they have utterly failed to implement such a system

HN31[] As explained in Caremark (which was expressly adopted by Stone), the first step in "implement[ing]" a reporting or information system is that corporate directors have a "duty to attempt in good faith" to establish an "adequate" one, meaning one "reasonably" designed to provide "timely," "accurate," and "sufficient" information. Caremark, 698 A.2d 959, 970 (emphasis added). If the allegations in the complaint, accepted as true, establish a *prima facie* showing that no such system exists, then by definition the directors **[**35]** have "utterly" failed to "implement" it and have "intentionally" failed to act in the face of the known duty to attempt to establish such a system. The burden then would be on the directors either to rebut that *prima facie* showing or to show that, despite the absence of such a system, they nevertheless made an "attempt in good faith" to do so. Id. (emphasis added).

Circumstantial evidence can establish such a *prima facie* showing that there is no system, such as the complaint's allegations of repeated transactions occurring without any board approval or ratification, when normally such transactions would require such approval. *See, e.g.*, Complaint (dkt. 1) ¶¶ 32, 34, 42, 44, 52 (no approval or ratification for four of the five CCCD Notes or the other CCCD Transactions, nor for the RHM Software Rights Transfer). That shifts the burden to the corporation's directors to show either that the complaint's *prima facie* showing is unfounded or that they did in fact attempt in good faith to establish an "adequate" system. *Compare, e.g.,* In re Polycom, Inc., 78 F.Supp.3d 1006, 1016 (N.D. Cal. 2015) ("Plaintiffs do not identify a single instance where internal controls were disregarded or red flags were ignored").

b. Alternatively, if a system exists but the [36] directors do not exercise "business judgment" in concluding that the system is "adequate," then they have utterly failed to implement a system sufficient to invoke the "business judgment" rule**

HN32[] Although there is great deference as to the nature of such a system ("the level of detail" is itself "a question of business judgment" (Caremark, 698 A.2d 959, 970)) the directors must have actually exercised "judgment" in establishing such a system before the business judgment rule applies. For example, if one board member's "system" is simply to assume that other board members will handle his or her responsibilities — without attempting to confirm that by some reasonable method, such as appropriate delegation to a subcommittee that reports back to the board — then there would not have been any exercise of business judgment. That is another form of utterly failing to implement a Caremark system. *See* Burt, 237 Cal.App.2d 828, 852-53, 47 Cal. Rptr. 392 (business judgment rule "presuppose[s] that judgment — reasonable diligence — has in fact been exercised").

Again, circumstantial evidence, such as the allegations in the complaint, can establish a *prima facie* showing that directors of a corporation have not exercised business judgment. That shifts the burden to those directors to rebut that **[**37]** *prima facie* showing and show that they did in fact exercise their business judgment in attempting in good faith to establish a system that was "reasonably" designed to provide them with "timely," "accurate," and "sufficient" information. Caremark, 698 A.2d 959, 970.

[*318] c. If directors do not use the system, or ignore its clear flaws, then they have "consciously" failed to monitor or oversee the corporation's

operations

HN33[] Once having set up such a system, directors are entitled to rely on it. But if they fail to use that system, or choose to ignore its clear flaws, then they have "consciously failed to monitor or oversee [the corporation's] operations thus disabling themselves from being informed of risks or problems requiring their attention." *Stone, 911 A.2d 362, 370* (emphasis added). This, too, can be shown by circumstantial evidence such as the allegations in the complaint.

Any one of the foregoing examples illustrate what would constitute, in the words of *Caremark*, a "sustained or systematic failure of the board to exercise oversight — such as an utter failure to attempt to assure a reasonable information and reporting system exits ...," or, as *Berg* put it, an "abdication" of duties. *Caremark, 698 A.2d 959, 971* (emphasis added); *Berg, 178 Cal.App.4th 1020, 1047, 100 Cal. Rptr. 3d 875*. Nothing in *Stone*'s brief summary **[**38]** of *Caremark* appears intended to change these things. To the contrary, *Stone* expressly approves the *Caremark* standard. *Stone, 911 A.2d 362, 369-70*. *See also* *Fed. Deposit Ins. Co. v. Faigin, 2013 U.S. Dist. LEXIS 94899, 2013 WL 3389490 at *14 n. 3 (C.D. Cal.)* (rejecting overbroad interpretation of *Berg*).

In sum, *HN34*[] the business judgment rule provides the Directors with a very substantial amount of deference, but not an unlimited amount. The complaint, including reasonable inferences thereunder, adequately alleges facts from which the plaintiff can plausibly assert that the requirements of the business judgment rule were not met.

Alternatively, assuming for the sake of discussion that the predicates to the business judgment rule existed, the plaintiff has argued that there are exceptions to it.

3. Conflicts of interest, including self-dealing, are exceptions to the business judgment rule

HN35[] The business judgment rule does not apply "in circumstances which inherently raise an inference of conflict of interest" nor to actions taken "with improper motives, or as a result of a conflict of interest." *Everest, 114 Cal.App.4th 411, 430, 8 Cal. Rptr. 3d 31*.

When self-dealing is involved the transaction will be scrutinized for fairness:

> Any transaction between the corporation and a director or a dominant or controlling stockholder, or group of stockholders, is subject to the following **[**39]** test: "Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein. ... The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain. If it does not, equity will set it aside." [*Burt, 237 Cal.App.2d 828, 850-51, 47 Cal. Rptr. 392 (1965)* (quoting *Pepper v. Litton, 308 U.S. 295, 306, 60 S. Ct. 238, 84 L. Ed. 281 (1939)* (other citations omitted).]

Delaware law is to the same effect. *HN36*[] The Delaware Supreme Court scrutinizes self-dealing transactions under the "entire fairness" standard, which it has described as follows (when examining a proposed merger):

> The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the **[*319]** transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the [transaction], including all **[**40]** relevant factors .... However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness. [*Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1162-63 (Del. 1995)* (citation omitted)]

At the pleading stage, plaintiff must allege sufficient facts to support a reasonable inference that material self-interest of one or more Directors could have infected or affected the board's deliberative process, and thereby change the standard of review from business judgment to entire fairness. *See* *Cinerama, 663 A.2d 1156* (extensive analysis of self-dealing and entire fairness issues).

These principles have also been partially codified in *California Corporations Code section 310* (*California § 310*), which provides in relevant part:

> HN37[] (a) No contract or other transaction between a corporation and one or more of its directors, or between a corporation and any corporation, firm or association in which one or more of its directors has a material financial interest, is either void or voidable because such director or directors or such other corporation, firm or association are parties or because such director or directors are present at the meeting of the board or a committee thereof which authorizes, approves or ratifies the **[**41]** contract or transaction, if
>
> > (1) The material facts as to the transaction and as to such director's interest are fully disclosed or known to the shareholders and such contract or transaction is approved by the shareholders (*Section 153*) in good faith, with the shares owned by the interested director or directors not being entitled to vote thereon, or
> > (2) The material facts as to the transaction and as to such director's interest are fully disclosed or known to the board or committee, and the board or committee authorizes, approves or ratifies the contract or transaction in good faith by a vote sufficient without counting the vote of the interested director or directors and the contract or transaction is just and reasonable as to the corporation at the time it is authorized, approved or ratified, or
> >
> > (3) As to contracts or transactions not approved as provided in paragraph (1) or (2) of this subdivision, the person asserting the validity of the contract or transaction sustains the burden of proving that the contract or transaction was just and reasonable as to the corporation at the time it was authorized, approved or ratified.
>
> A mere common directorship does not constitute a material financial interest within the **[**42]** meaning of this subdivision. A director is not interested within the meaning of this subdivision in a resolution fixing the compensation of another director as a director, officer or employee of the corporation, notwithstanding the fact that the first director is also receiving compensation from the corporation. [Emphasis added.]

The complaint includes a number of allegations of self-dealing. *See, e.g.*, Complaint (dkt. 1) ¶¶ 2, 3, 49, 60, 64. Those **[*320]** allegations, if proven, would establish exceptions to the business judgment rule.

4. Officers apparently are not protected by the business judgment rule in California; but that issue is not decided in this opinion because the complaint does not adequately distinguish between the defendants' alleged acts or omissions as officers and as directors

At least HN38[] in California, the business judgment rule apparently does not protect officers. *See Cal. Corp. Code § 309(a)-(c)*; *F.D.I.C. v. Perry, 2011 U.S. Dist. LEXIS 143222, 2012 WL 589569, at *4 (C.D. Cal.)* (under both California common law and the California Corporations Code, the business judgment rule "does not protect officers' corporate decisions"); *FDIC v. Van Dellen, 2012 U.S. Dist. LEXIS 146648, 2012 WL 4815159, at *6 & *14 n. 13 (C.D. Cal.)* ("California courts have not extended the rule to officers and this Court declines to do so.") (footnote omitted). *Cf. Biren v. Equality Emergency Medical Group, 102 Cal.App.4th 125, 138, 125 Cal. Rptr. 2d 325 (2002)* (although CFO acted without board **[**43]** approval, she was also director responsible for billing matters, and she was protected by the business judgment rule because the "trial court could reasonably infer that she mistakenly believed it was in the best interest of the corporation that she act with alacrity because the other directors could not").

That issue need not be decided in this opinion because, as argued by at least some of the Directors, the complaint does not sufficiently distinguish between their alleged acts and omissions as officers, as distinguished from their capacity as directors. *See* dkt. 43, pp. 17:1-18:11, *and* dkt. 50, pp. 14:12-15:17 (both citing *Brown v. Brewer, 2010 U.S. Dist. LEXIS 60863, 2010 WL 2472182, at *3 (C.D. Cal.)*). Accordingly, the plaintiff cannot rely on this exception to defeat the motions to dismiss. (But the plaintiff might be able to amend the complaint to make that distinction more clear, or might be able to establish at later stages of this litigation that a given defendant was acting as an officer and therefore cannot use the business judgment rule as a defense.) *See generally Gaillard v. Natomas Co., 208 Cal.App.3d 1250, 1265, 256 Cal. Rptr. 702 (1989)* (because directors "did not vote on the approval of the golden parachutes or consulting agreement ... they were not 'perform[ing] the duties of a director,' as specified in *section 309*, but were acting as officer **[**44]** employees of the corporation [and] [t]he judicial deference afforded under the business judgment rule therefore should not apply.").

5. Exculpatory provisions do not necessarily protect the Directors

HN39[] A corporation's governing documents generally can excuse directors from the duty of care but not the duty of loyalty or good faith. *See, e.g., Malpiede v. Townson, 780 A.2d 1075, 1095 (Del. 2001)*. That is particularly significant for *Caremark* duties because those have been held to be part of the duty of good faith so, at least in Delaware, exculpatory provisions cannot exonerate directors for violations of their *Caremark* duties. *See Stone, 911 A.2d 362, 367-70 (Del. 2006)*.[4]

That is hardly surprising: the whole point of having a board of directors is to oversee the corporation, so it would make **[*321]** no sense to permit them to be exculpated in advance for completely failing to oversee the corporation **[**45]** — *i.e.*, if they have "utterly failed to implement any reporting or information system or controls" or have "consciously failed to monitor or oversee" such a system or controls "thus disabling themselves from being informed of risks or problems requiring their attention." *Stone, 911 A.2d 362, 370*. This Bankruptcy Court anticipates that the California Supreme Court would reach the same conclusion: directors cannot be exculpated in the articles of incorporation from breaches of their *Caremark* duties.

In California the applicable statute is *Corporations Code section 204(a)(10)*, which states that the articles of incorporation may set forth:

> *HN40*[] Provisions eliminating or limiting the personal liability of a director for monetary damages in an action brought by or in the right of the corporation for breach of a director's duties to the corporation and its shareholders, as set forth in *Section 309*, provided, however, that (A) such a provision may not eliminate or limit the liability of directors (i) for acts or omissions that involve intentional misconduct or a knowing and culpable violation of law, (ii) for acts or omissions that a director believes to be contrary to the best interests of the corporation or its shareholders or that involve the absence **[**46]** of good faith on the part of the director, (iii) for any transaction from which a director derived an improper personal benefit, (iv) for acts or omissions that show a reckless disregard for the director's duty to the **[*322]** corporation or its shareholders in circumstances in which the director was aware, or should have been aware, in the ordinary course of performing a director's duties, of a risk of serious injury to the corporation or its shareholders, (v) for acts or omissions that constitute an unexcused pattern of inattention that amounts to an abdication of the director's duty to the corporation or its shareholders, (vi) under *Section 310*, or (vii) under *Section 316*, (B) no such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when the provision becomes effective, and (C) no such provision shall eliminate or limit the liability of an officer for any act or omission as an officer, notwithstanding that the officer is also a director or that his or her actions, if negligent or improper, have been ratified by the directors. [*Cal. Corp. Code § 204* (West) (emphasis added)]

Debtor's articles of incorporation do include an exculpation provision:

> The liability of the directors **[**47]** of the corporation for monetary damages shall be eliminated to the fullest extent permissible under California law. [*See* dkt. 41-5, exhibit A to Foust Declaration.]

The plaintiff argues that the Directors are not protected by this clause. The plaintiff is not persuasive on every issue, as noted in brackets below, but it has established that this exculpatory provision does not entirely protect the Directors from liability:

> First, exculpation does not apply to corporate officers. [As noted above, the complaint does not sufficiently distinguish between the defendants' alleged acts and omissions as officers, as distinguished from their capacity as directors, so the plaintiff's argument on this issue is insufficient.]
>
> Second, exculpation does not apply to self-dealing transactions [which the complaint alleges as against some Directors, but not as to others].
>
> Third, exculpation does not apply to "acts or missions that show a reckless disregard for the

[4] Notwithstanding the general rule that duty of care claims must be dismissed in the face of an exculpatory provision, "[w]hen a duty of care breach is not the *exclusive* claim" and is accompanied by a duty of loyalty claim that is not dismissed, there is authority that "the due care claim is not defeated by [*8 Del. C.] § 102(b)(7)*." *Cf. In re Bridgeport Holdings, Inc., 388 B.R. 548, 566-72 (Bankr. D. Del. 2008)* (citation omitted, emphasis in original). This opinion expresses no view on that issue.

director's duty to the corporation or its shareholders in circumstances where the director was aware, or should have been aware ..., of a risk of serious injury to the corporation or its shareholders." [The complaint (dkt. 1), at ¶¶ 85 & 93, alleges **[**48]** a reckless disregard as against all of the Directors.]

Fourth, exculpation does not apply to "acts or omissions that constitute ... an abdication of the director's duty to the corporation or its shareholders."

[As explained above, in discussing *Caremark* duties, the complaint does allege such "abdication" of duties.] [Dkt. 57, p. 18:3-12, emphasis added].

In sum, neither the business judgment rule nor the exculpatory clause in Debtor's articles of incorporation entirely protects the Directors from liability under the general corporate law of California (or the parallel laws of Delaware and other States). The next issue is what effect insolvency has.

D. Insolvency's Effect On Fiduciary Duties

HN41[] What principally changes upon insolvency is who can sue for breaches of fiduciary duties. Normally the fiduciary duties of care, loyalty, and good faith run not only to stockholders but also to the corporation itself, under the *California Corporations Code section 309*,[5] and decisions under that law,[6] as well as analogous decisions from Delaware[7] and other jurisdictions.[8] This is an unremarkable proposition. The defendants' assertions to the contrary — that directors' duties essentially run only to the stockholders — are belied **[*323]** by the plain words **[**49]** of the statute and the overwhelming weight of other authority.

Insolvency changes the situation, but the reported decisions struggle to explain how. The leading case in California is *Berg & Berg Enterprises, LLC v. Boyle, 178 Cal.App.4th 1020, 100 Cal. Rptr. 3d 875 (2009)*.

As *Berg* notes, traditionally ***HN44***[] in California and elsewhere "all of the assets of a corporation, immediately on its becoming insolvent, become a trust fund for the benefit of all of its creditors." *Berg, 178 Cal.App.4th 1020, 1040, 100 Cal. Rptr. 3d 875* (citations and internal quotation marks omitted, emphasis added). **[**51]** This raises the question of what it means for the corporation's assets to become a "trust fund" or, more generally, what are the directors' and officers' duties upon insolvency. For example, must the directors immediately liquidate the corporation and pay creditors?

1. Upon insolvency, duties to creditors do not

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[5] ***HN42***[] "A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances." *Cal. Corp. Code § 309(a)* (emphasis added). Likewise, ***California Corporations Code section 204(a)(10)*** provides that directors cannot be exculpated for breaching certain fiduciary duties to "the corporation or its shareholders." (Emphasis added.)

[6] *Berg & Berg Enterprises, LLC v. Boyle, 178 Cal.App.4th 1020, 1037, 100 Cal. Rptr. 3d 875 (2009)* ("It is without dispute that ***HN43***[] in California, corporate directors owe a fiduciary duty to the corporation and its shareholders and now as set out by statute, must serve 'in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders.'" (quoting *Cal. Corp. Code § 309(a)*) (emphasis added)).

[7] *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007)* ("It is well settled that directors owe fiduciary duties to the corporation.") (emphasis added); *Crescent/Mach I Partners, L.P. v. Turner, 846 A.2d 963, 979 (Del. Ch. 2000)* ("Directors have an unyielding fiduciary duty to protect the interests of the corporation and the stockholders alike.") (discussing fiduciary **[**50]** duties in the context of a merger, and recognizing the separate interests of the corporation and the shareholders) (emphasis added).

[8] *N.Y. Bus. Corp. Law § 717* (McKinney) (directors and officers should consider, inter alia, "both the longterm and the short-term interests of the corporation and its shareholders[.]") (emphasis added); *Bank of Am. Corp. v. Lemgruber, 385 F. Supp. 2d 200, 224 (S.D.N.Y. 2005)* ("A corporate officer or director generally owes a fiduciary duty only to the corporation over which he exercises management authority, and any breach of fiduciary duty claims arising out of injuries to the corporation in most cases may only be brought by the corporation itself or derivatively on its behalf.") (emphasis added) (citing *Abrams v. Donati, 66 N.Y.2d 951, 953, 489 N.E.2d 751, 498 N.Y.S.2d 782 (1985)*; *Somers ex rel. EGL, Inc. v. Crane, 295 S.W.3d 5, 11 (Tex. Ct. App. 2009)* ("A director's fiduciary duty runs only to the corporation, not to individual shareholders or even to a majority of the shareholders." (applying Texas law) (emphasis added)).

supersede or dilute duties to stockholders; rather, creditors join stockholders in being able to sue directors derivatively for breaches of fiduciary duties to the corporation that divert, dissipate, or unduly risk corporate assets

Berg concluded that ***HN45***[] "the scope of any extracontractual duty owed by corporate directors to the insolvent corporation's creditors is limited in California, consistent with the trust fund doctrine, *to the avoidance of actions that divert, dissipate, or unduly risk corporate assets that might otherwise be used to pay creditors['] claims*." *Berg, 178 Cal.App.4th 1020, 1041, 100 Cal. Rptr. 3d 875* (emphasis in original). As this phrase is interpreted below, this Bankruptcy Court is not persuaded that the California Supreme Court would reach any different conclusion.

a. The duty to avoid actions that "unduly risk" corporate assets is essentially the same as the duty outside of insolvency: to exercise business judgment [52] in an informed and good faith effort to preserve and grow the corporation's value**

Berg started by summarizing "modern" federal and "out-of-state" decisions (without necessarily following all of their holdings or dicta):

> [Those decisions] have underscored that when managing a corporation that is insolvent, directors must consider the best interests of the whole "corporate enterprise, encompassing all its constituent groups, without preference to any. That duty, therefore, requires directors to take creditor interests into account, but not necessarily to give those interests priority. In particular, it is not a duty to liquidate and pay creditors when the corporation is near insolvency, provided that in the directors' informed, good faith judgment there is an alternative. Rather, the scope of that duty to the corporate enterprise is 'to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity.'" [*Berg, 178 Cal.App.4th 1020, 1038, 100 Cal. Rptr. 3d 875* (emphasis added, citations omitted)]

Berg then explained the rationale of those decisions "for the general rule of no duty owed to creditors" outside of insolvency, and how the dynamics change upon insolvency:

> In an economic sense, when **[**53]** a corporation is solvent, it is the shareholders who are the residual claimants of the corporation's assets and who are the residual risk bearers. As long as the corporation remains solvent, the business decisions made by management directly affect the shareholders' income; management accordingly **[*324]** owes fiduciary duties to those shareholders as well as to the corporation. The corporation's creditors, on the other hand, are free to protect their interests by contract. As long as the corporation is solvent, no matter how badly managed it might be, it is able to satisfy its contractual obligations to creditors who are therefore unaffected by management's business decisions. But when insolvency arises, the value of creditors' contract claims may be affected by management's business decisions in a way it was not before insolvency. [*Berg, 178 Cal.App.4th 1020, 1038, 100 Cal. Rptr. 3d 875* (citations omitted)]

Having reviewed these modern trends and rationales, *Berg* then returned to decisions applying the "trust fund" doctrine under California law. ***HN46***[] *Berg* observed that "generally" any recovery for breaching the fiduciary duties imposed under the trust fund doctrine in California involved "cases where the directors or officers of an insolvent corporation **[**54]** have diverted assets of the corporation for the benefit of insiders or preferred creditors." *Id. at 1040-41* (internal quotations omitted). It interpreted California law not to create any "paramount fiduciary duty of due care or loyalty that directors of an insolvent corporation owe the corporation's creditors ..." nor any duty in an amorphous "zone" or "vicinity" of insolvency. *Id. at 1041* (emphasis added). *Berg* rejected the seminal *Credit Lyonnais* decision of the Delaware Court of Chancery to the extent it can be read to imply otherwise. *Id. at 1041 & n.22* (citing *Credit Lyonnais Bank Nederland N.V. v. Pathe Communications Corp., 1991 Del. Ch. LEXIS 215, 1991 WL 277613 (Del. Ch.))*.

Rather, ***HN47***[] *Berg* held, under California law the duty to creditors only arises upon insolvency and is limited "*to the avoidance*[9] *of actions that divert,*

[9] For at least two reasons, *Berg* apparently intended the word "avoidance" to include not just recovery of "diverted" property but also recovery of damages. First, assets that have been "dissipate[d]" cannot be recovered. Similarly, once risks have been triggered it makes no sense to "avoid" the action that triggered the risk. Second, *Berg* characterizes its holding as being "consistent with the trust fund doctrine" (*id. at 1041*) and the trust fund decisions that it cites include damage awards. *See Berg, 178 Cal.App.4th 1020, 1040, 100 Cal. Rptr. 3d 875*;

dissipate, or unduly risk corporate assets that might otherwise be used to pay creditors['] claims." Berg, 178 Cal.App.4th 1020, 1041, 100 Cal. Rptr. 3d 875 (italics in original, underlining added). The italicized words echo *Berg*'s recognition (a few paragraphs earlier) that "when insolvency arises" the "risk bearers" include creditors, and "the value of creditors' contract claims" can be directly jeopardized "by management's business decisions." Id. at 1038 (citations omitted). What *Berg* appears to mean by avoiding actions that "unduly risk" corporate assets is that directors **[**55]** must attempt to avoid asset depletion and instead "maximize the corporation's long term wealth creating capacity." *Id.* (summarizing modern federal and out-of-state decisions to that effect, citations omitted). That is consistent with authority from the Delaware Supreme Court that directors have a duty to attempt "to maximize the value of the insolvent corporation for the benefit of all **[*325]** those having an interest in it." Gheewalla, 930 A.2d 92, 103.[10]

What stands out about **HN48**[] this duty upon insolvency is that it is essentially, if not exactly, the same as the overall duty to stockholders and the corporation outside of insolvency: to exercise business judgment in an informed and good faith effort to preserve and grow the corporation's value. *See, e.g.,* Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140, 1150 (Del. 1990) (duty, outside of insolvency, to manage corporation to attempt to "enhance corporate profitability").

What changes upon insolvency is the constituency: the creditors are now "risk bearers" so they now have the right, like stockholders, to bring a derivative action in **[**58]** the corporation's name against directors who "unduly risk" corporate assets. *See* Berg, 178 Cal. App. 4th 1020, 1027 & n.6, 1041 & n.22, 100 Cal. Rptr. 3d 875 (distinguishing creditor's lack of direct claim with their ability to bring derivative claims). *See also, e.g.,* Gheewalla, 930 A.2d 92, 103 (no "direct" claims by creditors, and no "zone" of insolvency, but directors can be sued derivatively for violation of duty to attempt "to maximize the value of the insolvent corporation for the benefit of all those having an interest in it") (cited favorably by Berg, 178 Cal.App.4th 1020, 1041 n.22, 100 Cal. Rptr. 3d 875); Production Resources v. NCT Group, 863 A.2d 772, 791 (Del. Ch. 2004) (upon insolvency directors "continue to have the task of attempting to maximize the economic value of the firm" and "[t]hat much of their job does not change" but what does change is "the constituency on whose behalf the directors are pursuing that end" which now includes creditors) (footnote omitted), *criticized on other grounds by, e.g.,* Berg, 178 Cal.App.4th 1020, 1038 & 1039 n. 18, 100 Cal. Rptr. 3d 875 (rejecting any implicit adoption of zone of insolvency or creditors' direct claims, as

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and see, e.g., In re Jacks, 266 B.R. 728, 732 & *passim* (9th Cir. BAP 2001) (action for nondischargeability of $116,882.25 contract and common count damages); Commons v. Schine, 35 Cal.App.3d 141, 145, 110 Cal. Rptr. 606 (1973) (measure of damages was amount of unjust enrichment); Saracco Tank & Welding Co. v. Platz, 65 Cal.App.2d 306, 150 P.2d 918 (1944) (liability for dereliction imposed on directors for wrongful distribution of all assets of insolvent corporation for **[**56]** payment to preferred creditors).

[10] *See* William P. Weintraub (Updated by Debra Grassgreen), *Reorganizing High-Tech Businesses — "I Need Help, Find Me Some Lawyers Who Wear Suits"*, 2002 Ann. Surv. of Bankr.Law 9, at 220 (2002):

> Generally speaking, under recent cases in other jurisdictions addressing the expanded duties of directors upon insolvency, the duties of directors of insolvent companies have been identified as a duty not to divert, dissipate or unduly risk assets that are necessary to pay the claims of creditors. *See* In re Ben Franklin Retail Stores, Inc., 225 B.R. 646 (Bankr. N.D. Ill. 1998), *aff'd in part*, 43 Collier Bankr. Cas. 2d (MB) 9, 1999 WL 982963 (N.D. Ill. 1999), *opinion amended and superseded*, 2000 U.S. Dist. LEXIS 276, 2000 WL 28266 (N.D. Ill. 2000); Geyer v. Ingersoll Publications Co., 621 A.2d 784 (Del. Ch. 1992); *and* Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., 17 Del. J. Corp. L. 1099, 1991 Del. Ch. LEXIS 215, 1991 WL 277613 (Del. Ch. 1991). What does this mean? As a practical matter, the expanded duties upon insolvency mean that the board of directors cannot disregard the superior interests and rights of creditors to be paid ahead of shareholders. Thus, high-risk strategies, or strategies that are not supported by reasonable assumptions and realistic expectations may, with the benefit of hindsight, subject directors to personal liability for implementing an improvident strategy that unnecessarily dissipates the corporation's **[**57]** assets while seeking (perhaps blindly) the ever elusive new equity investor or asset purchaser in an environment where neither option is realistically available to the corporation. In such circumstances, if the "cash burn" erodes what might otherwise have been a fair recovery for creditors, directors who have embarked upon a mistaken, ill conceived, or thoughtless strategy may be found to be liable to creditors for the erosion in asset value or diminution in cash. Similarly, the absence of any analysis or demonstrable awareness of how certain options affect certain constituencies may also be evidence of the breach of duty.

opposed to derivative claims); Quadrant Structured Prods. Co., Ltd. v. Vertin, 115 A.3d 535, 546 (Del. Ch.) ("After a corporation becomes insolvent, creditors gain standing to assert claims **[*326]** derivatively for breach of fiduciary duty.") (footnote omitted).[11]

b. Berg's policy concerns are resolved by this interpretation, i.e., that directors' duties before and after insolvency are essentially, if not exactly, the same: to attempt to preserve and grow corporate value

Berg expressed two policy concerns. First, Berg was concerned that any "paramount" duty to creditors "would conflict with" and "dilute" duties that directors already owe to shareholders and the corporation. Berg, 178 Cal.App.4th 1020, 1041, 100 Cal. Rptr. 3d 875. But no such conflict or dilution arises if the duty is always the same, both before and after insolvency: to attempt to preserve and grow corporate value.

Second, *Berg* perceived "practical problems" with creating a paramount duty to creditors, "among them a director's ability to objectively and concretely determine when a **[**60]** state of insolvency actually exists such that his or her duties to creditors have been triggered." *Id.* (emphasis added). That would be a very real concern if duties changed radically upon insolvency, because it is so difficult to tell when the line of insolvency is crossed.

For example, the balance sheet test is easy to state in theory, but in practice it requires a "fair" valuation of assets. This means that directors cannot rely on book value, or value for accounting or tax purposes, or any other valuation that is likely to be readily available. *See, e.g.,* *Quadrant Structured Products Co. v. Vertin, 102 A.3d 155, 176-77 (Del. Ch. 2014)* ("balance sheet" is a misnomer because the balance sheet is only the starting point of the analysis); *Prod. Res. Grp. LLC v. NTC Grp. Inc., 863 A.2d 772, 775 (Del. Ch. 2004)*.

Similarly, as to cash flow insolvency or inadequate capitalization, a corporation may have accounts receivable that have not yet been collected, causing some delays in payments, and it is ambiguous at what point such delays tip the balance into a general inability to pay debts when due, either now or in the foreseeable future. *See, e.g.,* *In re Dill, 731 F.2d 629, 632 (9th Cir.1984)* ("finding that a debtor is generally not paying his debts requires a more general showing of the debtor's financial condition and debt structure than merely establishing the existence of a few **[**61]** unpaid debts") (citations omitted). *See also* Cal. Civ. Code § 3439.01, Legislative Committee Comment 3 (court should take into account proportion of debts not being paid, duration of nonpayment, existence of bona fide disputes, etc.).

But these ambiguities in each type of "insolvency" are far less troublesome if no new duties are "triggered" by insolvency. ***HN49***[↑] Under the foregoing interpretation of Berg and California law, no new duties are triggered. Directors' duty remains essentially if not entirely unchanged: to attempt to preserve and grow corporate value.

This interpretation is also consistent with the trend in decisions in Delaware (and other States, as noted in Berg). As one monograph states:

> [U]nder Delaware law, fiduciary duties of directors and officers of financially troubled companies run to the corporation itself, and not to the unique constituencies interested in the corporation. **[*327]** Coupled with the protection afforded by the business judgment rule, Delaware law affords managers of troubled companies a broad discretion to act in the long-term interests of the corporation without worry that their actions will draw fire from either shareholders or creditors. ... ["The] creditors of an insolvent firm have no greater **[**62]** right to challenge a disinterested, good faith business decision than the stockholders of a solvent firm.["] [Christopher W. Frost, *Corporate Governance in Insolvency and Bankruptcy* (Collier Monograph, A. Resnick & H. Sommer Eds.) (2011) ("Frost, *Corp. Governance in Insolvency*") § 3[3], at pp. 33-34 (footnotes omitted).]

But there is a caveat. In the next sentence that same monograph goes on to note:

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[11] For purposes of the analysis in this opinion, it does not matter whether directors' duties upon insolvency are duties **[**59]** to creditors *per se*, or instead duties to the corporation which in turn has a duty to pay creditors. Either way, the directors have to take into account the corporation's obligation to pay creditors. *See* Quadrant, 115 A.3d 535, 546-47 ("The directors of an insolvent firm do not owe any particular duties to creditors. They continue to owe fiduciary duties to the corporation for the benefit of all of its residual claimants, a category which now includes creditors.") (footnotes omitted).

> The remaining problem, however is that this focus on the corporation obscures the conflicts between creditors and shareholders that lie at the heart of managerial decision-making. Most decisions of significance implicate conflicts between classes of investors. ... [*Id.*, emphasis added.]

This is another very real potential problem, but as the emphasized language implies it is not unique to the insolvency situation: it applies to any conflicts between different groups of "investors." For example, directors often have to choose among conflicting constituencies when a majority of stockholders favor a course of action that a minority claims would violate their rights. *See, e.g., Paramount, 571 A.2d 1140*. *See also Production Resources, 863 A.2d 772, 797 (Del. Ch. 2004)* (analogizing to conflicts among groups of stockholders), *criticized on other grounds by, e.g., Berg, 178 Cal.App.4th 1020, 1038 & 1039 n. 18, 100 Cal. Rptr. 3d 875*.

In each instance **[**63]** the solution, to which *Berg* alluded, is for directors to exercise their business judgment in a good faith attempt to act in the best interests of the whole corporate enterprise, encompassing all its constituent groups, without undue preference to any, consistent with the goal of preserving and growing corporate value. This concept is explored further below.

2. What it means to act in the best interests of the whole corporate enterprise, encompassing all its constituent groups, without undue preference to any

HN50[] Stockholders and creditors are likely to have different approaches to risk, especially upon insolvency. Creditors, "holding fixed claims, generally prefer corporate decisions that minimize the risk of failure," whereas stockholders "generally prefer risky strategies because they profit from the success of [those] decisions but share the losses with creditors if the decisions fail." Frost, *Corp. Governance in Insolvency* § 2, at p. 6.

If directors acted solely at the direction of creditors they might take on too little risk, from the standpoint of "maximiz[ing] the corporation's long-term wealth creating capacity." *Berg, 178 Cal.App.4th 1020, 1038, 100 Cal. Rptr. 3d 875* (citation and internal quotation marks omitted). Conversely if they acted solely at **[**64]** the direction of stockholders they might take on too much risk. *See generally* Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, *46 Vand. L. Rev. 1485, 1489 (1993)*.

Only one rational approach to resolve those differences appears to have been suggested in the reported decisions (or in the commentary that the parties have cited or that this Bankruptcy Court has found). That approach is for the directors to exercise their business judgment **[*328]** in a good faith attempt to weigh the likely value of each proposed course of action, taking into account both the risks and the potential rewards, and then choose whichever has the best chance to preserve and increase value of the corporation as a whole, for the benefit of all constituent groups. In other words, ***HN51***[] when faced with conflicting constituencies, directors are protected by the business judgment rule if they attempt in good faith to follow their overall duty to attempt to preserve and enhance corporate "profitability" or "value." *Paramount, 571 A.2d 1140, 1150*; *Gheewalla, 930 A.2d 92, 103*. *See also Credit Lyonnais, 1991 Del. Ch. LEXIS 215, 1991 WL 277613 at n.55 (Del. Ch. Dec. 30, 1991)* (expressing same concept of maximizing value using a hypothetical discounted present value analysis to assess different courses of action), *criticized on other grounds by Berg, 178 Cal.App.4th 1020, 1038, 1041, 100 Cal. Rptr. 3d 875 & n.22* **[**65]** (declining to follow *Credit Lyonnais* to the extent it stands for any duties to creditors in the "vicinity of insolvency," or any "paramount" duty to creditors upon insolvency).[12]

HN52[] Corporate directors have enormous discretion in exercising their business judgment to weigh the alternative courses of action, **[**66]** within the "broad

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[12] *See* Robin E. Phelan, Tom D. Harris, Eric Terry, Eric D. Poole, *If Their Business Judgment Was So Good How Come They're in Bankruptcy and Other Perplexing Mysteries of the Business Judgment Rule: Corporate Governance Issues for the Financially Troubled Company*, 10 J. Bankr. L. & Prac. 471, 475-76 (2001) ("In insolvency, the directors' duties are to multiple constituencies. [citing *Credit Lyonnais*]. In *Credit Lyonnais*, Chancellor Allen noted that in insolvency the duty runs not directly to the creditors but to the "community of interest." Therefore, it appears that the duty does not necessarily place creditor interests ahead of the interests of stockholders, but requires the board to maximize the corporation's longterm wealth creating capacity. *Id.* In footnote 55, Chancellor Allen addressed the problem of directors' duties in insolvency by posing a complex numerical hypothetical. *Id.*").

mandate" to attempt to preserve and enhance corporate profitability/value. *Paramount, 571 A.2d 1140, 1150*; *Gheewalla, 930 A.2d 92*. That includes not only how to enhance profitability/value but also on what time frame - short term or long term - because directors can "chart[] a course for a corporation which is in its best interests without regard to a fixed investment horizon." *Paramount, 571 A.2d 1140, 1150*. Corporate directors "do not have a duty to shut down the insolvent firm and marshal its assets for distribution to creditors, although they may make a business judgment that this is indeed the best route to maximize the firm's value." *Quadrant Structured Products Co., Ltd. v. Vertin, 115 A.3d 535, 546-47 (Del. Ch. 2015)* (footnotes omitted). Conversely, "[e]ven when a firm is insolvent, its directors may, in the appropriate exercise of their business judgment, take action that might, if it does not pan out, result in the firm being painted in a deeper hue of red. The fact that the residual claimants of the firm at that time are creditors does not mean that the directors cannot choose to continue the firm's operations in the hope that they can expand the inadequate pie .... " *Trenwick Am. Litigation Trust v. Ernst & Young, 906 A.2d 168, 174 (Del. Ch. 2006)*. Within the broad scope of their exercise of business judgment, directors are protected from liability if these decisions are "second guessed" by either creditors **[**67]** or stockholders.

3. The alternative - duties that change substantially upon insolvency - would be unworkable because creditors' and stockholders' interests diverge near insolvency

The preceding sections of this discussion conclude that directors' duties remain essentially **[*329]** if not entirely unchanged upon insolvency - to attempt to preserve and grow corporate value - and what principally changes is that creditors join stockholders as constituents for whose benefit the corporate enterprise is managed. The alternative to essentially unchanging duties would be for directors' duties to change substantially upon insolvency. That would be unworkable, not only for the reasons stated in *Berg* but also because the closer to the line of insolvency, the more divergent the interests of stockholders and creditors are likely to be. Consider three hypothetical situations: when the corporation is very solvent, very insolvent, or close to the line of insolvency.

a. Very solvent

Suppose that a corporation has $100 million of assets and $50 million of liabilities. Stockholders have a financial incentive for the corporation not to take excessive risks, because they have $50 million of net equity to lose. Creditors **[**68]** are protected both by the stockholders' self-interest and by the equity cushion. Therefore, when a corporation is very solvent the interests of stockholders and creditors generally align (all other things being equal).

b. Very insolvent

Now suppose that the same corporation is very insolvent: it has $5 million of assets and $100 million of liabilities. Stockholders, are woefully "out of the money" so they have nothing meaningful to lose and everything to gain if the corporation engages in a very high risk, high return strategy -- to "bet the farm" or "swing for the fences." Creditors similarly have little to lose: rather than split $5 million of assets among their $100 million in claims (a theoretical 5% distribution) they also have an incentive to try a high risk, high return strategy. Therefore, when a corporation is very insolvent, the interests of stockholders and creditors once again may align (true, stockholders' risk tolerance still may be higher than that of creditors, but in general their interests are aligned). *See* Frost, Corp. *Governance in Insolvency* ¶ 3[1] at p. 28, n.18.

c. Close to the line of insolvency

Next consider situations close to the line of insolvency. Suppose that **[**69]** the corporation is slightly insolvent: say $95 million of assets and $100 million of liabilities. Stockholders are still out of the money so they still have a strong incentive to swing for the fences, but creditors have a strong incentive to cut their losses by having the corporation sell its assets at fair market value (for a theoretical 95% return), rather than engage in even moderately risky ventures. Creditors' interests have diverged sharply from those of stockholders. *See generally* Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency*, *46 Vand. L. Rev. 1485, 1489-93* (divergent interests in (1) level of risk, (2) distribution of dividends, (3) incentives to liquidate, and (4) new investments).

Now suppose that the corporation is slightly solvent: assets are worth $105 million and liabilities are still $100 million. Now stockholders have something to lose ($5 million) but that may well be so little, when divided among all of them and compared to their investments in the corporation, that they still have a strong incentive to swing for the fences, whereas creditors still have a strong incentive to protect their thin equity margin (theoretically 5%, but more likely 0% or negative after costs of sale) and have **[**70]** the corporation avoid even moderately risky ventures. Again, their interests sharply diverge.

In sum, the closer to the line of insolvency, the more likely it is that stockholders will have nothing to lose and everything to gain by taking excessively large risks, and conversely the more likely that creditors will have the opposite incentive to take **[*330]** minimal if any risks. If crossing some invisible line of insolvency switches directors' duties from stockholders to creditors, then directors would be in an impossible situation: their risk tolerance would have to switch suddenly from very high (for stockholders, prior to insolvency) to very low (for creditors after insolvency). These policy considerations are additional reasons to interpret California law as described above, in keeping with the concerns expressed by *Berg* and numerous other decisions and commentators.

4. All three definitions of insolvency probably apply, and alternatively the balance sheet and cash flow tests apply

The foregoing discussion and hypotheticals largely focus on the balance sheet measure of insolvency. It appears, however, that all three methods of determining insolvency probably apply under *Berg* and similar decisions **[**71]** in Delaware and other States.

The parties have not pointed to any governing statutory definition of insolvency for purposes of fiduciary duties, nor has this Bankruptcy Court's research revealed any.[13] The reported decisions do not devote much attention to this issue, although there are some conclusory statements that the balance sheet and cash flow tests apply. *See, e.g., Pereira v. Farace, 413 F.3d 330, 343 (2d Cir. 2005)* (asserting that Delaware courts define insolvency using cash flow and balance sheet tests). *Berg* noted that there are "multiple definitions of insolvency" but it did not decide among them because the plaintiff in that case "did not plead any facts establishing [the corporation's] insolvency at any specific point in time under any test, only the conclusion that at all relevant times, the corporation was insolvent or in the zone of insolvency." *Berg, 178 Cal.App.4th 1020, 1042 n.23, 100 Cal. Rptr. 3d 875*.

HN53[] As the Ninth Circuit has observed in attempting to define insolvency in an analogous context, when there is "little legislative guidance" it is appropriate to consider "underlying policies" of the law. *In re Dill, 731 F.2d 629, 632 (9th Cir. 1984)* (evaluating insolvency for purposes of an involuntary bankruptcy petition under *§ 303(h)(1)*). The most relevant underlying policy is for directors to avoid actions **[**73]** that "unduly risk" corporate assets that might otherwise be used to pay creditors' claims. *Berg, 178 Cal.App.4th 1020, 1041, 100 Cal. Rptr. 3d 875*. Guided by this policy, if a corporation is in recognizable financial distress then its actions should be dictated by that financial reality, regardless how that distress is manifested. After all, that is why the different tests of insolvency evolved.

[*331] For example, a corporation can have a positive balance sheet but be completely unable to pay its debts as they come due - *e.g.*, it cannot make payroll. In that situation the corporation is clearly in financial distress and it would seem inappropriate for the directors to ignore the corporation's financial distress simply because, looking only at the balance sheet, its assets exceeded its liabilities.

Similarly, although a corporation may be currently paying its debts and have assets that exceed present liabilities, nevertheless it can be doomed to fail - *e.g.*, after an improvident leveraged buyout - and therefore be insolvent under the inadequate capital test. *See*

[13] Some statutes apply in other contexts, but they are not very helpful to the analysis. *See, e.g.*, *Cal. Corp. Code § 501* (cash flow insolvency is applied for purposes of a rigid prohibition on shareholder distributions: "Neither a corporation nor any of its subsidiaries shall make any distribution to the corporation's shareholders (*Section 166*) if the corporation or the subsidiary making the distribution is, **[**72]** or as a result thereof would be, likely to be unable to meet its liabilities (except those whose payment is otherwise adequately provided for) as they mature."). *Compare 6 Del. Code § 1302* (fraudulent transfer statute, not fiduciary duty) ("A debtor is insolvent if the sum of the debtor's debts is greater than all of the debtor's assets, at a fair valuation. A debtor who is generally not paying debts as they become due is presumed to be insolvent."); *and 8 Del. Code § 291* (using the word "insolvent" without further definition in the context of court appointment of receiver(s) for an "insolvent" corporation); *U.C.C. § 1-201(b)(23)* ("'Insolvent' means: (A) having generally ceased to pay debts in the ordinary course of business other than as a result of bona fide dispute; (B) being unable to pay debts as they become due; or (C) being insolvent within the meaning of federal bankruptcy law.").

generally *Moody v. Security Pacific Business Credit, Inc., 971 F.2d 1056, 1065-75 & n.22 (3rd Cir. 1992)* (extensive analysis, in fraudulent transfer context, of inadequate capital test of insolvency, recognizing its close relationship to cash flow insolvency but distinguishing it **[**74]** as focusing on the "reasonable foreseeability" that lack of capital would lead to an "inability to generate enough cash flow to sustain operations").

Accordingly, ***HN54***[] it seems likely that the California Supreme Court, if faced with the issue, would hold that all three tests of insolvency apply: balance sheet, cash flow, and inadequate capitalization. Alternatively, if only balance sheet insolvency and cash flow insolvency were to apply, that would not change the conclusions in this opinion except as noted below when discussing the adequacy of the complaint's allegations of insolvency.

5. Officers have not been shown to have different overall duties from directors, although they apparently do not have the protections of the business judgment rule

The foregoing analysis focuses on directors. As for officers, their apparent lack of protection by the business judgment rule has been discussed, but in other respects the parties have not pointed to any differences. They appear to have the same general duties of due care, loyalty and good faith, as well as the same overall duties to attempt to preserve and increase the corporation's value. *Gantler v. Stephens, 965 A.2d 695, 708 (Del. 2009)* (***HN55***[] "[C]orporate officers owe fiduciary duties that are identical to those **[**75]** owed by corporate directors.").

E. The Complaint Adequately Pleads Insolvency: It Need Not Allege Insolvency Under Every Test As To Every Claim

Under the foregoing analysis of fiduciary duties, the fact of insolvency might appear at first to be irrelevant because it does not change directors' and officers' duties in any material way, if at all. Nevertheless, insolvency is important for the plaintiff's standing. The plaintiff cannot sue on behalf of creditors except for breaches of fiduciary duties that occurred when the corporation was insolvent or was rendered insolvent (and, although theoretically the plaintiff could sue on behalf of other constituencies, he cannot sue on behalf of stockholders due to ratification, as discussed below). *See* Opposition (dkt. 57), p. 19:2-11. In any event, insolvency is important for purposes of the avoidance statutes.

The Directors argue that the complaint does not adequately plead insolvency. Their argument is unpersuasive.

As explained in more detail in the next two subsections of this discussion, the complaint expressly alleges - for almost all claims and at almost all times - that Debtor was insolvent under the balance sheet, cash flow, and inadequate **[**76]** capitalization tests. The complaint's allegations also include explanations and examples (the "Additional Insolvency Allegations") asserting **[*332]** that at all relevant times Debtor's assets lacked reliable value, its expenses were high and unsustainable, it faced liquidity challenges, and its net revenue was dangerously thin. Those Additional Insolvency Allegations do double duty: they support the express allegations of insolvency and, standing on their own, they adequately assert insolvency under the inadequate capitalization test.

That is sufficient. As described above, ***HN56***[] insolvency by any measure is sufficient for purposes of bringing derivative breach of fiduciary duty claims on creditors' behalf. In addition, insolvency by any measure is sufficient for purposes of one or another of the avoidance statutes.

1. Specific articulation of all three tests

The complaint specifically alleges (except as to the claims for breach of fiduciary duty) that Debtor "(a) was engaged in a business or a transaction for which its remaining assets were unreasonably small in relation to that business or transaction [*i.e.*, inadequate capitalization], (b) intended to incur, or believed or reasonably should have **[**77]** believed that it would incur, debts beyond its ability to pay as they came due [*i.e.*, cash flow insolvency], and/or (c) was insolvent in that, at a fair valuation, the sum of [Debtor's] debts were greater than the sum of [Debtor's] assets [*i.e.*, balance sheet insolvency]." Complaint (dkt. 1) ¶ 115. *See also id. at, e.g.*, ¶¶ 139, 145, 162, 168, 175, 181, 186, 188, 193.

These specific allegations of all three types of insolvency span the entire relevant period prior to the Petition Date, except for 2011:

July 5, 2007 (¶¶ 31, 42, 161, 162, 168, First CCCD

> Note) October 31, 2007 (¶¶ 32, 42, 161, 162, 168, Second CCCD Note) June 20, 2008 (¶¶ 33, 42, 161, 162, 168, Third and Fourth CCCD Notes) March 9 through May of 2009 (and early 2010) ¶¶ 56, 61, 173, 175, 181, 186, 188, 193, initial transactions regarding 2100 Grand Property) December 9, 2009 (¶¶ 42, 161, 162, 168, Fifth CCCD Note) 2010 generally (¶ 27, alleging that expenses were 106.9% of revenue) December of 2010 (¶¶ 60-61, 173, 175, 181, 186, 188, 193 Additional Transfers to Primary Directors related to refinance of the 2100 Grand Property) May of 2012, approximately (¶¶ 71 & 199, Weinberg PTO Payments) November of 2012 (¶¶ 44, 137, **[**78]** 139, 145, 150, 152, 157 CCCD Note Sale) Late 2012 (¶¶ 50-52, 115, 121, 128, 133, RHM Software Rights Transfer)

Even in 2011, a year in which Debtor "experienced some profit" (Complaint (dkt. 1) ¶ 79), the complaint alleges that the Directors "drained [Debtor] of its liquidity at a time when the company's financials were unsustainable" (in connection with accruing over $10 million in unpaid PTO and sabbatical leave as of April 2011, and permitting executives and supervisors to cash out those benefits). *Id. ¶¶ 70-71* (emphasis added). In addition, the complaint alleges that in September of 2011, when Debtor filed its 2010 tax return that did not use the NOLs for a tax refund, Debtor had "liquidity challenges" and was "in need of cash." *Id. ¶ 76* (emphasis added). These allegations adequately state inadequate capitalization in 2011.

All of these allegations of insolvency are also incorporated by reference into the claims for corporate waste (¶ 211), unjust enrichment (¶ 215), equitable subordination (¶ 221), and the objections to the Directors' claims (¶¶ 225, 228, 231, 234, 237, 240, 243). Under a fair reading of the complaint, it **[*333]** alleges that Debtor was insolvent at all relevant times under **[**79]** all three tests of insolvency, except that in 2011 it alleges only inadequate capitalization.

It is true that no express allegations of insolvency are made as to the claims for breach of fiduciary duty. *Id. ¶¶ 83-110*. But the plaintiff presumably could seek leave to amend the complaint to add those allegations, because the alleged breaches of fiduciary duty are based on, and were simultaneous with, the same underlying acts and omissions as the other claims, as to which the complaint expressly alleges insolvency. *Id. ¶¶ 64-71, 76*, 85-87, & 93-94. Amending the complaint is not essential for the breach of fiduciary duty claims, however, because as set forth below the complaint adequately alleges inadequate capitalization even without any express allegation of insolvency.

2. The Additional Insolvency Allegations not only support the express allegations of all three types of insolvency; they also sufficient allege, standing on their own, inadequate capitalization

The complaint alleges that at all relevant times Debtor's assets lacked reliable value, its expenses were high and unsustainable, it faced liquidity challenges, and its net revenue was dangerously thin. These are the Additional Insolvency **[**80]** Allegations referred to above.

The complaint alleges that from at least 2007, Debtor's valuation of its assets was unreliable. As to its valuation of work in progress, it used a "percentage-ofcompletion" method of accounting but, given ever more "extreme project delays and cost overruns," its percentage of completion could "never be accurately predicted." Complaint (dkt. 1) ¶ 26. As for other assets, substantial loans to related companies and insiders "appeared to have little value, yet they were still being recorded at their face amount." *Id.*

The complaint alleges that Debtor "was crushed by the weight of excessive labor costs and accompanying benefit programs" as it "added hundreds of employees to its U.S. operations" without "planning or foresight." *Id. ¶ 25*. Debtor's Los Angeles office had approximately 375 employees in 2005, which "nearly doubled to more than 700 employees in 2007 and 2008." *Id.* The Directors, "[e]ager to promote a 'culture,' rather than sustain a business," had "basked in the breadth of human resources" and fostered "an underutilized and irrationally expensive labor force." *Id. ¶ 26*. Other allegedly gross mismanagement throughout the relevant periods "caused large, repeated **[**81]** and unmanageable losses." *Id. ¶ 65*.

According to the complaint, Debtor had "dangerously thin net revenue." *Id. ¶ 27*. Its ratio of total expenses to production revenue decreased from 75.7% in 2007 to 96.1% in 2008 to 97.2% in 2009 to 106.9% in 2010 (net loss). *Id.* In fact, Debtor's "dangerously thin" net revenue turned into actual losses of more than $6.7 million in 2010 and $22.5 million in 2012. *Id. ¶¶ 28-29*.

Even in 2011, as noted above, the complaint alleges that the Directors "drained [Debtor] of its liquidity at a time when the company's financials were unsustainable." Id. ¶¶ 70-71 (emphasis added). In addition, the complaint alleges that in September of 2011, when Debtor filed its 2010 tax return that did not use the NOLs for a tax refund, Debtor had "liquidity challenges" and was "in need of cash." Id. ¶ 76 (emphasis added)

All of the foregoing allegations (*i.e.*, the Additional Insolvency Allegations) are incorporated by reference into every claim stated in the complaint. *See, e.g., id*. ¶ 83. **[*334]** As noted above, these allegations support the express allegations of insolvency.

It is true that, standing on their own, these Additional Insolvency Allegations are insufficient to establish **[**82]** balance sheet insolvency. "[U]ncertain" asset values and debts that eventually "crushed" Debtor do not necessarily mean that Debtor is balance sheet insolvent at a "fair" valuation as of every relevant time. *See* § 548(a)(1)(B)(ii)(I) (requiring "fair" valuation"); Cal. Civ. C. § 3439.02 (same). But these allegations are sufficient to support the express allegations of balance sheet insolvency as of all of the times listed in the preceding subsection of this discussion. At the pleading stage, the Directors should not be able to hide behind their own (allegedly) unreliable books and records to assert that asset values have not sufficiently been shown to be less than liabilities. It is not clear what more the defendants would require of the plaintiff at the pleading stage: a "fair" valuation of assets and liabilities almost certainly will require expert testimony, which is inappropriate to require on a motion to dismiss.

The same analysis applies to cash flow insolvency. It is true that having "liquidity" problems, being "in need of cash" and similar allegations do not necessarily amount to cash flow insolvency. But those allegations are sufficient to support the express allegations of cash flow insolvency.

Furthermore, the Additional **[**83]** Insolvency Allegations, standing on their own, are sufficient to allege inadequate capitalization. To summarize those allegations: Debtor's assets lacked reliable value, its expenses were high and unsustainable, it faced liquidity challenges, and its net revenue was dangerously thin. Those things essentially define what it means to lack adequate capitalization. Therefore, even as to the claims for breach of fiduciary duty that do not expressly allege insolvency (Complaint (dkt. 1) ¶¶ 83-110), there are sufficient allegations of inadequate capitalization.

For all of these reasons, the complaint's allegations of insolvency are sufficient.

F. The Complaint States A Claim That The Directors Breached Their Fiduciary Duties; And The Directors Have Not Established As A Matter Of Law The Adequacy Of Their Defenses

The ***HN57***[] Directors had duties (both upon insolvency and at all times) of care, loyalty and good faith, all in service of the ultimate duty not to "divert, dissipate, or unduly risk corporate assets." Berg, 178 Cal.App.4th 1020, 1041, 100 Cal. Rptr. 3d 875 (emphasis omitted). *See also* Paramount, 571 A.2d 1140, 1150 (duty to attempt to "enhance corporate profitability"); Gheewalla, 930 A.2d 92, 103 (duty to attempt to "maximize" corporate value). The complaint adequately alleges numerous acts and omissions **[**84]** that, if proven, appear to establish a *prima facie* breach of those fiduciary duties.

For example, the CCCD Transactions allegedly involved self-dealing loans to Hughes' and Ts'O's family business, with no legitimate business purpose, at high risk, without board approval (except as to the first loan), and with a $1 buyout by Hughes after the gamble had paid off, causing Debtor a loss of $1.89 million. Likewise, the RHM Software Rights Transfer allegedly involved self-dealing, a last minute transfer of key software to the overseas affiliate owned by the Principal Directors, for no consideration, and without board approval. There are similarly troubling allegations regarding the 2100 Grand Transactions and the Loss of NOLs. Those alleged breaches support claims of violations of the duty of loyalty and good faith, and the duty of care, including both affirmative acts and failure of **[*335]** oversight - breach of Caremark duties. The plaintiff, acting in its capacity as liquidating trustee under the plan, has standing to bring claims for breaches of those fiduciary duties.

With one exception, the Directors have not established that either the exculpatory provisions of the debtor's articles of incorporation **[**85]** or the business judgment rule insulates them, as a matter of law, from the claims in the complaint. That exception is for the so-called Reckless Operational Acts, as to which the defendants' motions for a more definite statement or, alternatively, motions to dismiss will be granted (subject to the plaintiff's opportunity to seek leave to amend). The directors' individual situations are reviewed below.

1. Hughes

For numerous alternative reasons, Hughes has not established that he is protected either by the exculpatory provision of Debtor's articles of incorporation or business judgment rule (except as to the Reckless Operational Acts).

a. The complaint adequately alleges grounds on which the exculpatory provisions of Debtor's articles of incorporation may not apply, and also alleges more than ordinary negligence, as to which the business judgment rule is not a shield

The complaint allegations regarding Hughes' acts and omissions come within one or more exceptions to the exculpatory provisions of Debtor's articles of incorporation, such as for self-dealing, lack of good faith, intentional misconduct, reckless disregard of duties, or "for acts or omissions that constitute an unexcused pattern **[**86]** of inattention that amounts to an abdication of the director's duty to the corporation." *Cal. Corp. C. § 204(a)(10)(i)-(v)*. Likewise, the complaint's allegations are that Hughes acted intentionally, recklessly, or with gross negligence, and those things are sufficient to overcome the business judgment rule, which only shields directors as to ordinary negligence.

Those allegations of ultimate fact are supported - except as to the Reckless Operational Acts - with sufficiently specific subsidiary allegations to meet the "plausibility" and other requirements in the context of a motion to dismiss. *See, e.g.*, Complaint (dkt. 1) ¶¶ 32, 34, 42, 44, 52 (no approval or ratification for four of the five CCCD Notes or the other CCCD Transactions, nor for the RHM Software Rights Transfer); *id. at ¶¶ 3, 49, 53, 60, 64* (self-dealing as to numerous transactions); *and id.* ¶ 76 (regarding the Loss of NOLs, allegations that NOLs could have been fully used if carried back and instead were wasted by being carried forward; that companies "never" make such elections; and that Hughes testified that "issues like this were never presented to him, and that no board meeting addressed this issue").

Hughes (and the remaining Directors) **[**87]** argue that they should be granted some leeway because closely held corporations tend to operate informally. "Larger corporations often have formal board committees to recommend the approval of a variety of corporate actions," but "small corporations like [Debtor] conduct much of their official business informally," and "this is especially so where the members of the board personally conduct the business of the corporation." Dkt. 61, p.3 n. 2 (citations omitted). Assuming without deciding that this informality gives the Directors some sort of greater leeway in how they fulfill their duties, there is a difference between "informally" reviewing and approving transactions and failing even minimally to review or approve them. The complaint alleges the latter.

[*336] In addition, any corporate informality cuts both ways at this pleading stage. Hughes (and the remaining Directors) can hardly expect the plaintiff to be more specific about exactly what role each one had in each transaction if they were too informal to document their decisions. *See generally* *In re MIPS Tech., Inc., 2008 U.S. Dist. LEXIS 108486, 2008 WL 3823726 at *8 (N.D. Cal.)* (taking into consideration what information is or is not available to plaintiff).

As to the Reckless Operational Acts, however, the complaint's **[**88]** allegations are conclusory and are insufficient in view of the heavy burden that discovery and litigation would impose on Hughes. *See, e.g.,* *Am. Apparel, 2012 U.S. Dist. Lexis 146970 at *54 (C.D. Cal.)* (***HN58***[] to be entitled to presumption of truth, allegations in complaint (a) must not simply recite elements of claim but must contain sufficient allegations of underlying facts to give fair notice and enable opposing party to defend itself effectively and (b) must plausibly suggest an entitlement to relief, "such that it is not unfair to require the opposing party to be subjected to the expense of discovery and continued litigation") (quoting *Starr v. Baca, 652 F.3d 1202, 1216 (9th Cir. 2011))*.

HN59[] Gross negligence requires a showing of failure to exercise "even slight care." Cal. Prac. Guide: Corps., Ch. 6-C (citation omitted). Although it is entirely possible that it was grossly negligent (or even reckless or willful misconduct) to adopt the PTO and sabbatical policies that the board is alleged to have done, it is also entirely possible that such policies were precisely what was needed to attempt to shore up morale, or retain key personnel, or for any other legitimate goal; or at least the Directors may have concluded as much, in the good faith exercise of their business judgment. The complaint does not **[**89]** allege, for example, that the policies adopted by Debtor were contrary to practices that are universally or almost universally accepted in the circumstances presented (as the complaint does allege with the Loss of NOLs).

In sum, the complaint adequately alleges much more than ordinary negligence (except as to the Reckless

Operational Acts). Neither the exculpatory provisions of Debtor's organizing documents nor the business judgment rule acts as a shield for such conduct. Therefore, except with respect to the Reckless Operational Acts, Hughes has not established as a matter of law that he is shielded from liability.

b. Alternatively, the complaint's allegations shift the burden to Hughes to show that the board ever established a system to provide adequate information to the board

Alternatively, even if the complaint's assertions of more than ordinary negligence were not adequately alleged (which they are), Hughes could be liable for ordinary negligence in some circumstances. As noted above, the exculpatory provisions of Debtor's articles of incorporation do not apply in some instances, such as for self-dealing or lack of good faith. *Cal. Corp. C. § 204(a)(10)(ii)* & *(iii)*. The business judgment rule adds an **[**90]** additional layer of protection to shield Hughes, if it applied, but at this preliminary stage of the litigation Hughes cannot establish as a matter of law that it does apply.

The complaint's allegations are that repeated transactions occurred without any board approval or ratification, when normally such transactions would require such approval. *See, e.g.*, Complaint (dkt. 1) ¶¶ 32, 34, 42, 44, 52. That establishes a *prima facie* showing that no system was ever created by Debtor's board that was reasonably designed to provide adequate information to the board. *Caremark, 698 A.2d 959, 970*. Alternatively and additionally, **[*337]** the complaint's allegations of unchecked self-dealing and needless Loss of NOLs also establish a *prima facie* showing that no such system was ever created. *Id. at ¶¶ 3, 49, 53, 60, 64*, 74-80. That shifts the burden to Hughes either to rebut that *prima facie* showing or to prove that, despite the absence of an adequate information and reporting system, the board made an "attempt in good faith" to establish such a system. *Caremark, 698 A.2d 959, 970* (emphasis added).

In these circumstances a "ruling on the applicability of the business judgment rule is peculiarly a question of fact, wholly inappropriate for consideration on a **[**91]** motion to dismiss." *Fed. Sav. and Loan Ins. Corp. v. Musacchio, 695 F.Supp. 1053, 1064 (N.D. Cal. 1998)*; *see Resolution Trust Corp. v. Heiserman, 839 F.Supp. 1457, 1464, 1465 (D. Colo. 1993)* (***HN60***[] "the business judgment rule is a fact bound affirmative defense which provides no basis for dismissal under *Rule 12(b)(6)*") *impliedly overruled on other grounds in F.D.I.C. v. Schuchmann, 235 F.3d 1217 (10th Cir. 2000)*; *Gaillard, 208 Cal.App.3d at 1267-68*.

Hughes will have the opportunity to present evidence, either on summary judgment or at trial. He cannot establish at this preliminary stage of the litigation, however, that as a matter of law the business judgment rule shields him from liability.

c. The complaint's allegations shift the burden to Hughes to show that the board ever exercised any business "judgment" in attempting in good faith to establish an adequate information or reporting system

If, for the sake of argument, it could be shown that an attempt actually was made to establish an "adequate" information and reporting system, under the complaint's allegations such attempt was so entirely unsuccessful as to constitute a *prima facie* showing that the directors utterly failed to exercise their business judgment in attempting in good faith to establish a system that was reasonably designed to provide them with timely, accurate, and sufficient information. *Caremark, 698 A.2d 959, 970*; *Burt, 237 Cal.App.2d 828, 852-53, 47 Cal. Rptr. 392* (business judgment rule "presuppose[s] that judgment — reasonable diligence — has in fact been exercised"). **[**92]** Again, that shifts the burden to Hughes, so he cannot establish at this stage that as a matter of law the business judgment rule shields him from liability.

d. The complaint's allegations shift the burden to Hughes to show that the board actually used the information or reporting system, and did not ignore clear flaws in it

If, for the sake of argument, it could be shown that an adequate system actually was established, under the complaint's allegations the Directors either chose not to use that system at all, or chose to ignore its clear flaws. This establishes a *prima facie* showing that there was a "sustained or systematic failure of the board to exercise oversight," an "abdication" of duties, or, put differently, a "conscious[] fail[ure] to monitor or oversee [the corporation's] operations." *Caremark, 698 A.2d 959, 971*; *Berg, 178 Cal.App.4th 1020, 1047, 100 Cal. Rptr. 3d 875*; *Stone, 911 A.2d 362, 370*. This is an alternative reason why Hughes cannot establish this defense as a matter of law.

e. The business judgment rule does not protect Hughes as to self-interested transactions

If, for the sake of argument, it could be shown that an adequate system actually was established and used, without ignoring obvious flaws, then Hughes still cannot use the business judgment rule as a shield at **[*338]** this stage **[**93]** of the litigation as to any of the transactions on which he is alleged to have been self-interested. The complaint alleges, for example, that he was self-interested in the CCCD Transfers and negotiated the unsecured convertible promissory notes on behalf of both Debtor and CCCD. *See* Complaint ¶ 30-42. Additionally, Hughes was a director and officer of Debtor and was a director, officer, and stockholder of CCCD, Inc., which owned 100% of CCCD, at the time of various CCCD Transactions as to which Hughes was on both sides. Similar arguments can be made as to Hughes and the RHM Software Transfer and the 2100 Grand Transaction. This is an alternative reason why Hughes cannot establish this defense, as a matter of law, as to every allegedly self-interested transaction.

f. Conclusion as to Hughes

Hughes has not established that he is shielded by either the exculpatory provisions of Debtor's articles of incorporation or the business judgment rule against the allegations in the complaint. He will have the opportunity to rebut the allegations in the complaint, either on summary judgment or at trial, but he has not established that, as a matter of law, he is entirely shielded from liability at **[**94]** this preliminary stage of the litigation.

2. Other Primary Directors: Ts'O and Goldfarb

Essentially the same analysis applies with respect to Ts'O and Goldfarb. They are not alleged to have been quite as involved as Hughes in every purported selfdealing transaction, but in other respects the allegations against them are essentially the same, and the legal analysis and outcome is exactly the same.

3. The Other Directors: Lee Berger, Prashant Buyyala, Raymond Feeney, and David Weinberg

With regard to the Other Directors, the complaint adequately alleges that they breached their fiduciary duties. Each of the transactions (like the CCCD Note Sale (Complaint ¶ 44), the RHM Software Rights Transfer (Complaint ¶ 52), the NOL carry forward (Complaint ¶ 80), and the 2100 Grand Transactions (Complaint ¶ 63)) allegedly involved either (1) a complete failure of the board — intentionally, recklessly, or with gross negligence — to address issues that they knew about or as to which they were on notice or (2) was the result of an utter failure of *Caremark* supervision and an abdication of oversight duties.

For example, selling the entire, valuable $1.89 million series of series of CCCD convertible notes **[**95]** to Hughes for his promise of $1 (the CCCD Note Sale), without any board approval, appears on its face to be a complete failure of the board to act, and an abdication of any oversight duties. Likewise, transferring Debtor's key software, "which had been developed over decades and used to win multiple awards in the film industry" (Complaint (dkt. 1) ¶ 54), to the Primary Directors' overseas business, RHM, for no consideration and with no board approval, appears on its face to be another complete failure of the board to act and an abdication of any oversight duties. The other alleged acts and omissions (except for the so called Reckless Operational Acts) similarly establish plausible claims for breaches of fiduciary duties by the Other Directors.

The allegations in the complaint, supported by subsidiary allegations, also sufficiently establish grounds to overcome the exculpatory provisions of Debtor's articles of incorporation and the business judgment rule. The analysis is the same as for Hughes, with two exceptions. First, the only specific allegations of self-dealing involving the Other Directors are with respect to the Weinberg PTO Payments. **[*339]** Second, Weinberg allegedly had a direct **[**96]** role as CFO in the Loss of NOLs.

As for Feeney's status as an independent, outside, and disinterested director, it appears that, if the allegations in the complaint and reasonable inferences are accepted as true, there is a *prima facie* showing that he too failed to follow his obligations under *Caremark* and *Stone*. Although he might be able to establish that there was an acceptable *Caremark* system established by the board pursuant to which he was only present to provide expertise and was entitled to rely on the remaining directors as to many types of board decisions, that is a highly factual issue. *Cf.* *Cal. Corp. C. § 309(a)* & *(b)(3)*. Mr. Feeney also might benefit from the fact that, ***HN61***[] under California law at least, he will not be held to any sophisticated business standard but instead to the standard of an ordinary prudent person. *See* [*Frances T. v. Village Green Owners Assn., 42 Cal. 3d 490, 526-28, 229 Cal. Rptr. 456, 723 P.2d 573 (1986)*] (under a statute that imposes the "same standard that [[*Cal. Corp. Code § 309*]] imposes on directors of commercial corporations," the duty of care is that of "ordinarily prudent person," which emphasizes "long traditions of the common law, in contrast to standards that might call for some undefined degree of expertise, like 'ordinarily prudent businessman'") (quoting Assembly Select Committee **[**97]** Report, quoting ABA Committee Report).

4. Conclusion as to alleged breaches of fiduciary duties

For all of the foregoing reasons, the complaint states a claim that the Directors breached their fiduciary duties (except as to the so-called Reckless Operational Acts), and the Directors have not established as a matter of law the adequacy of their defenses. They may be able to establish defenses after discovery, on summary judgment, or at trial, but at this preliminary stage of the litigation they have not done so.

5. Group Pleading

Several of the Directors complain that the plaintiff has improperly pled allegations as to the Primary Directors and the Other Directors, rather than as to each director or officer individually. *See, e.g.*, Feeney Reply (dkt. 64), pp. 3:1-6:2. The plaintiff argues persuasively that, to the extent that "group pleading" is a disfavored legal concept at all, it is appropriate here. *See* Opposition (dkt. 57), pp. 15:9-16:6; *see also* [*In re Am. Apparel, Inc. S'holder Derivative Litig., No. CV 10-06576 MMM RCX, 2012 U.S. Dist. LEXIS 146970, 2012 WL 9506072, at *41 (C.D. Cal.)*]. ***HN62***[] When directors and officers have engaged in similar conduct, alleging claims as to the whole group of similarly situated directors and officers is sufficient. *See* [*George v. Kraft Foods Global, Inc., 674 F.Supp.2d 1031, 1050 (N.D. Ill. 2009)*] ("because **[**98]** the determination of a party's fiduciary status with respect to a particular activity in this case is a fact-sensitive inquiry, such a determination is best left for a later stage of these proceedings" so "dismissal of the Defendants on this basis at this stage is premature.").

6. Stockholder ratification

HN63[] Stockholder ratification does not apply to any claims of breaches of fiduciary duty while Debtor was insolvent. *See, e.g.,* [*In re JTS Corp., 305 B.R. 529, 539, 541 (Bankr. N.D. Cal. 2003)*] (recognizing that, ***HN64***[] when a corporation is insolvent, the trust fund doctrine "fundamentally alters the relationship between a corporation, its shareholders and its creditors" and that "corporate or shareholder ratification does not apply to creditors who would be prejudiced thereby."). *See also* Opposition (dkt. 57) pp. 18:13-20:14. *Compare* [*GSM, 2013 Bankr. Lexis* ***[*340]*** *3298, at *129-30*] (stockholders were free to dispose of corporate assets however they chose, "so long as the corporation was not insolvent or rendered insolvent," and at trial plaintiff failed to prove insolvency, so even if acts were detrimental to the corporation, unanimous stockholder ratification meant that there was no legal recourse in favor of the corporation as a separate entity).

Without such a rule, the effect of the trust fund doctrine **[**99]** would be defeated by the very stockholders whose conduct is challenged, or the very directors and officers who acted for the stockholders' benefit in derogation of creditors' rights. Ratification does not protect the Directors.

G. Statutes of Limitations and Related Arguments

The plaintiff's arguments regarding the statutes of limitation, tolling, and related arguments are persuasive at this early stage of the litigation, for the most part. *See* Opposition (dkt. 57), pp. 30:5-34:15. There are two exceptions.

First, the continuous violation doctrine has not been sufficiently established. [*Id.*], pp. 32:14-33:18. But that is only an alternative argument to the plaintiff's arguments regarding equitable tolling, the discovery rule, and the adverse domination doctrine, which are sufficiently persuasive for present purposes. [*Id.*], pp. 31:8-32:13. *See also, e.g.,* [*Prudential-LMI Commercial Ins. v. Superior Ct., 51 Cal.3d 674, 274 Cal. Rptr. 387, 798 P.2d 1230 (1990)*]; [*E-Fab, Inc. v. Accountants, Inc., Servs., 153 Cal.App.4th 1308, 64 Cal. Rptr. 3d 9 (2007)*]; [*Admiralty Fund v. Peerless Ins. Co., 143 Cal.App.3d 379, 191 Cal. Rptr. 753 (1983)*]; *and see* [*April Enterprises, Inc. v. KTTV, 147 Cal.App.3d 805, 827-33, 195 Cal. Rptr. 421 (1983)*] (discovery rule explained, and applicable to claim for breach of fiduciary duty); [*Schneider v. Union Oil Co. of Cal., 6 Cal.App.3d 987, 993-94, 86 Cal. Rptr. 315 (1970)*] (summarizing authority that corporation's own innocence is insufficient to overcome discovery rule regarding breach of fiduciary duty claim); *Whitten v. Dabney, 171 Cal. 621, 629, 154 P. 312 (1915)* (knowledge by one stockholder of wrongful acts is not imputed to different stockholder); *Ashou v. Liberty Mutual Fire Ins. Co., 138 Cal.App.4th 748, 757, 41 Cal. Rptr. 3d 819 (2006)* (explaining five policy **[**100]** considerations behind equitable tolling). *See generally* *Aryeh v. Canon Bus. Solutions, Inc., 55 Cal.4th 1185, 1192, 151 Cal. Rptr. 3d 827, 292 P.3d 871 et seq. (2013)* (explaining differences between discovery rule, equitable tolling, fraudulent concealment, continuing violation, continuous accrual, etc.).

Second, as the plaintiff concedes, the so-called Original Transfers in Counts 18 and 19 of the complaint are beyond the two year reach back period for those claims. *Id.*, p. 34:3-6. The defendants' motions to dismiss will be granted as to those claims.

H. The Complaint States A Claim For Corporate Waste

The directors argue that the plaintiff has not sufficiently alleged waste because the allegations do not rise to the level that the challenged transactions were "unconscionable" (dkt. 37, pp. 24:17-26:5; dkt. 41, p. 24:1-25; dkt. 42, pp. 15:18-17:3) or that the facts alleged are insufficient to show that the transactions had no rational business purpose (dkt. 43, pp. 19:7-20:13). These contentions are unavailing.

HN65[↑] "Claims of corporate waste in California are based upon Delaware state law." *Swingless Golf Club Corp. v. Taylor, 679 F.Supp.2d 1060, 1070 (N.D. Cal. 2009)*. *Swingless Golf* continues:

> To recover on a claim of corporate waste, [defendants] must shoulder the **[*341]** burden of proving that the exchange was so one sided that no business person of ordinary, sound judgment **[**101]** could conclude that the corporation has received adequate consideration. *See* *In re Walt Disney Co. Derivative Litig., 906 A.2d 27, 74 (Del.2006)* (A claim of waste will arise only in the rare, unconscionable case where directors irrationally squander or give away corporate assets. This onerous standard for waste is a corollary of the proposition that where business judgment presumptions are applicable, the board's decision will be upheld unless it cannot be attributed to any rational business purpose.). [*Swingless Golf, 679 F.Supp.2d 1060, 1070* (quoting *In re Asyst Technologies, Inc. Derivative Litigation, 2008 U.S. Dist. LEXIS 41173, 2008 WL 2169021, at *10 (N.D.Cal.))* (emphasis added)].

At the pleading stage the plaintiff need only state a plausible claim for relief, and as detailed above the complaint alleges numerous transactions that are self-interested or very one sided. Hughes, for example, was allegedly self-interested in the CCCD Transfers, the RHM Software Rights Transfer, and the 2100 Grand Transfer. Additionally, and certain alleged transaction terms appear to have been so far below reasonable that they had no apparent business purpose (*e.g.*, transfers of valuable assets for $-0-, or the Loss of NOLs in a way that would "never" be done by other corporations). The Directors allege that there were valid business purposes for what Debtor did — *e.g.*, structuring transactions to satisfy the requirements **[**102]** of third party lenders — but that is a factual issue that cannot be resolved on a motion to dismiss. *See e.g.*, dkt. 37, p. 21:3-11.

There is one exception. As with the breach of fiduciary duty claims, the allegations related to the Reckless Operational Acts are not so egregious or out of the ordinary to sustain a claim of waste, at least without subsidiary supporting allegations. *See* Complaint ¶¶ 64, 65, 66, 69, 70.

As to the Other Directors, the complaint includes sufficient subsidiary allegations to make plausible the assertions they knew or should have known of the corporate waste, and are liable in the same manner as those directors who authorized the transactions. *See* *In re World Health Alternatives, Inc., 385 B.R. 576, 593 (Bankr. D. Del. 2008)* (even when there was no allegation that the corporate vice president and general counsel "personally benefitted from the alleged expenditures[,] given the fact that we must view the allegation in the light most favorable to the [plaintiff]," the court denied the motion to dismiss waste claim against him).

I. The Complaint's Objections To The Directors' Proofs Of Claim Survive The Motions To Dismiss Or For A More Definite Statement

The Directors, in essence, contend that their claims against Debtor survive for the same **[**103]** reasons that the plaintiff's claims against them fail. For example, Feeney argues that his claim based on indemnification should survive because the trustee has not sufficiently alleged bad faith so as to disqualify him from indemnification under applicable California law (dkt. 41, p. 26:6-20). Weinberg argues, in essence, that the Trustee's efforts to disallow his claim are derivative from the other allegations and cannot be sustained (dkt. 43., pp. 21:6-13). Because of the other rulings set forth above, those arguments are unpersuasive at this preliminary stage of the litigation.

J. The Complaint Adequately States A Claim For Equitable Subordination

The Directors argue that the plaintiff has not sufficiently alleged bad faith or inequitable conduct (*see* dkt. 41, p. **[*342]** 25:1-24; dkt. 43, pp. 20:14-21:5 (arguing that Weinberg actually warned the remaining Directors regarding fiduciary obligations and attempted to get better terms for the CCCD Notes)) and that the plaintiff's equitable subordination claims are "wholly derivative" of the (purportedly defective) claims for breach of fiduciary duty and corporate waste and should be dismissed (dkt. 42, p. 17:5-13).

HN66[] In the Ninth Circuit, a plaintiff **[**104]** must sufficiently allege three elements in order to state a claim for equitable subordination:

> Equitable subordination requires that: (1) the claimant who is to be subordinated has engaged in inequitable conduct; (2) the misconduct results in injury to competing claimants or an unfair advantage to the claimant to be subordinated; and (3) subordination is not inconsistent with bankruptcy law. [*Stoumbos v. Kilimnik, 988 F.2d 949, 958 (9th Cir. 1993)* (quoting *In re Universal Farming Indus., 873 F.2d 1334, 1337 (9th Cir.1989))]*.

HN67[] The burden of establishing equitable subordination is very heavy. For example, even aiding and abetting fraud does not necessarily establish grounds for equitable subordination. *See In re First Alliance Mortg. Co., 471 F.3d 977, 1006-7 (9th Cir. 2006)* (although "there is surely something 'inequitable' in an abstract sense about aiding and abetting fraud," that conduct did not "did not amount to the kind of fraud meant to be remedied by equitable subordination of bankruptcy claims") (citations omitted).

On the other hand, a wide range of inequitable conduct can, depending on the particular facts and circumstances, support a claim of equitable subordination. The issue is highly dependent on the specific facts presented. *See In re Granite Partners, LP, 210 B.R. 508, 515 (Bankr. S.D.N.Y. 1997)* ("allegations of aiding and abetting [a third party's] fraud also satisf[ied] the pleading requirement for equitable subordination"). In addition, **[**105]** when a complaint "seeks to subordinate 'a claim arising from the dealings between a debtor and an insider,' the court will give the insider's actions rigorous scrutiny.'" *Stoumbos, 988 F.2d at 959* (quoting *In re Fabricators, Inc., 926 F.2d 1458, 1465 (5th Cir.1991))*.

In this case the alleged transactions adequately establish possible grounds for equitable subordination. For example, according to the complaint, several of the Directors personally engaged in self-dealing transactions without the requisite scrutiny and approval by disinterested board members (such as the CCCD Transfers, the CCCD Note Sale, and the RHM Software Rights Transfer) and allegedly they did so on terms that were entirely one sided in favor of themselves and disadvantage to other creditors such as unpaid employees. Even those Directors who did not personally benefit allegedly abdicated their duties by permitting such one sided self-dealing to happen (repeatedly). At this early stage of the litigation, when the well pled allegations in the complaint must be accepted as true, the Directors have not established how the complaint fails to state a claim for equitable subordination.

Although Weinberg asserts that he cautioned the remaining Directors to take care to comply with their fiduciary obligations, **[**106]** he too is alleged to have engaged in inequitable conduct. He allegedly did not follow through when the other Directors (allegedly) failed to heed his advice, and allegedly he was on both sides of the Weinberg PTO payment and potentially received an unfair advantage over other claimants.

[*343] With regard to the remaining Directors, including Feeney (barely), this Bankruptcy Court is convinced that the plaintiff has adequately alleged inequitable conduct. The plaintiff has not alleged any inequitable conduct other than their alleged failure to abide by *Caremark* and *Stone* duties, but those allegations in themselves may be sufficient to support a claim for equitable subordination.

VI. CONCLUSION

For the foregoing reasons, the motions to dismiss and motions for more definite statements will be GRANTED IN PART and DENIED IN PART by separate orders. Nevertheless, those orders will not be issued for the moment, because the parties expect to engage in some limited discovery and attempted mediation before being faced with potential deadlines to file motions for reconsideration (*Rules 9023* and *9024*) or to seek whatever review they believe is appropriate by an appellate court or an Article III Court. Any related procedural **[**107]** issues will be addressed at the next status conference.

Date: March 11, 2016

/s/ Neil W. Bason

Neil W. Bason

United States Bankruptcy Judge

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Berg & Berg Enterprises, LLC v. Boyle

Court of Appeal of California, Sixth Appellate District

October 29, 2009, Filed

H031591

Reporter
178 Cal. App. 4th 1020 *; 100 Cal. Rptr. 3d 875 **; 2009 Cal. App. LEXIS 1740 ***

BERG & BERG ENTERPRISES, LLC, Plaintiff and Appellant, v. JOHN BOYLE et al., Defendants and Respondents.

Subsequent History: Rehearing denied by Berg & Berg Enterprises, LLC v. Boyle, et al., 2009 Cal. App. LEXIS 1920 (Cal. App. 6th Dist., Nov. 24, 2009)

Review denied by Berg & Berg Enterprises LLC. v. Boyle (John), 2010 Cal. LEXIS 1461 (Cal., Feb. 3, 2010)

Prior History: [*1]** Superior Court of Santa Clara County, No. CV044686, Neal Anthony Cabrinha, Judge.

Berg & Berg Enterprises, LLC v. Sherwood Partners, Inc., 131 Cal. App. 4th 802, 32 Cal. Rptr. 3d 325, 2005 Cal. App. LEXIS 1193 (Cal. App. 6th Dist., 2005)

Core Terms

insolvency, demurrer, fiduciary duty, third amended complaint, business judgment rule, net operating loss, breach of fiduciary duty, cause of action, trust fund, allegations, shareholders, financing, assignee, pleaded, dissipated, cases, zone, leave to amend, alleged facts, trial court, reorganization, diverted, rebut, board of directors, details, risked, sustain a demurrer, business judgment, unduly, reasonable inquiry

Case Summary

Procedural Posture
Appellant, a creditor of an insolvent corporation, sought review of a judgment from the Superior Court of Santa Clara County (California), which sustained, without leave to amend, respondent directors' demurrers to the creditor's complaint alleging breach of fiduciary duty.

Overview

The corporation entered into an assignment for the benefit of creditors. The complaint alleged that the directors had failed to investigate the possibility of a bankruptcy reorganization through which the corporation's accumulated net operating losses might have been carried forward. The court held that no duty arose from operating in the zone or vicinity of insolvency and that the scope of any extra-contractual duty owed by the directors to the creditors under Corp. Code, § 309, subd. (a), was limited under the trust fund doctrine to avoiding actions that would divert, dissipate, or unduly risk corporate assets that might otherwise be used to pay creditors' claims, including self-dealing or preferential treatment of creditors. Thus, the pleading failed to state a claim because such actions were not alleged. The court further held that the pleading failed to allege sufficient facts to avoid the application of the business judgment rule under § 309 and the common law because the creditor did not allege facts establishing that a reorganization reasonably could have been implemented. Leave to amend was properly denied because the creditor's proposed new facts did not cure the defects.

Outcome
The court affirmed the judgment of the trial court.

LexisNexis® Headnotes

Civil Procedure > Appeals > Standards of Review > De Novo Review

Civil Procedure > ... > Responses > Defenses, Demurrers & Objections > Demurrers

HN1[] Standards of Review, De Novo Review

A demurrer tests the sufficiency of the complaint as a matter of law; as such, it raises only a question of law. Thus, the standard of review on appeal is de novo. In reviewing the sufficiency of a complaint against a general demurrer, the appellate court treats the demurrer as admitting all material facts properly pleaded, but not contentions, deductions or conclusions of fact or law. The appellate court also consider matters which may be judicially noticed. Further, the appellate court gives the complaint a reasonable interpretation, reading it as a whole and its parts in their context. When a demurrer is sustained, the appellate court determines whether the complaint states facts sufficient to constitute a cause of action. Where a demurrer is to an amended complaint, the appellate court may consider the factual allegations of prior complaints, which a plaintiff may not discard or avoid by making contradictory averments, in a superseding, amended pleading. It is not the ordinary function of a demurrer to test the truth of the plaintiff's allegations or the accuracy with which he describes the defendant's conduct. A demurrer tests only the legal sufficiency of the pleading.

Civil Procedure > ... > Responses > Defenses, Demurrers & Objections > Demurrers

Civil Procedure > Appeals > Standards of Review > General Overview

HN2[] Defenses, Demurrers & Objections, Demurrers

An appellate court will affirm a trial court's decision to sustain a demurrer if it was correct on any theory. Accordingly, the appellate court does not review the validity of the trial court's reasoning but only the propriety of the ruling itself.

Civil Procedure > Appeals > Standards of Review > Abuse of Discretion

Civil Procedure > ... > Responses > Defenses, Demurrers & Objections > Demurrers

Civil Procedure > ... > Pleadings > Amendment of Pleadings > Leave of Court

HN3[] Standards of Review, Abuse of Discretion

Where a demurrer is sustained without leave to amend, the reviewing court must determine whether there is a reasonable probability that the complaint could have been amended to cure the defect; if so, it will conclude that the trial court abused its discretion by denying the plaintiff leave to amend. The plaintiff bears the burden of establishing that it could have amended the complaint to cure the defect.

Civil Procedure > Judgments > Relief From Judgments > Altering & Amending Judgments

Civil Procedure > ... > Responses > Defenses, Demurrers & Objections > Demurrers

HN4[] Relief From Judgments, Altering & Amending Judgments

Where a prior demurrer has been sustained as to some causes of action but overruled as to others, case law has held that a defendant may not demur again on the same grounds to those portions of an amended pleading as to which the prior demurrer was overruled. But where there is only one cause of action and the prior demurrers to that cause of action were sustained, this is a critical difference. And when a plaintiff files an amended pleading in response to an order sustaining a prior demurrer to a cause of action with leave to amend, the amended cause of action is treated as a new pleading and a defendant is free to respond to it by demurrer on any ground. Accordingly, where defendants have demurred to a single cause of action of an amended complaint as to which no prior demurrer has been overruled, the restrictive provisions of Code Civ. Proc., § 1008, are inapplicable. Moreover, there has been some case law concluding that a party is within its rights to successively demur to a cause of action in an amended pleading notwithstanding a prior unsuccessful demurrer to that same cause of action.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > General Overview

HN5[] Management Duties & Liabilities, Fiduciary Duties

In California, corporate directors owe a fiduciary duty to the corporation and its shareholders and, as set out by statute, must serve in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders. Corp. Code, § 309, subd. (a). This duty--generally to act with honesty, loyalty, and good faith--derives from the common law.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty to Third Parties

HN6[] Fiduciary Duties, Duty to Third Parties

California case law has applied the trust fund doctrine where all of the assets of a corporation, immediately upon becoming insolvent, become a trust fund for the benefit of all creditors in order to satisfy their claims. Recovery for breaching the fiduciary duties imposed under the trust-fund doctrine in California generally pertains to cases where the directors or officers of an insolvent corporation have diverted assets of the corporation for the benefit of insiders or preferred creditors. While no California cases expressly limit the fiduciary duty under the trust fund doctrine to the prohibition of self-dealing or the preferential treatment of creditors, the scope of the trust fund doctrine in California is reasonably limited to cases where directors or officers have diverted, dissipated, or unduly risked the insolvent corporation's assets. In other words, the doctrine is not applied to create a duty owed by directors to creditors solely due to a state of corporate insolvency. Application of the doctrine requires, in addition, that directors have engaged in conduct that diverted, dissipated, or unduly risked corporate assets that might otherwise have been used to satisfy creditors' claims.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty to Third Parties

HN7[] Fiduciary Duties, Duty to Third Parties

There is no broad, paramount fiduciary duty of due care or loyalty that directors of an insolvent corporation owe the corporation's creditors solely because of a state of insolvency. Any such duty would conflict with and dilute the statutory and common law duties that directors already owe to shareholders and the corporation. There would be practical problems with creating such a duty, among them a director's ability to objectively and concretely determine when a state of insolvency actually exists such that his or her duties to creditors have been triggered. Accordingly, the scope of any extra-contractual duty owed by corporate directors to the insolvent corporation's creditors is limited in California, consistently with the trust-fund doctrine, to the avoidance of actions that divert, dissipate, or unduly risk corporate assets that might otherwise be used to pay creditors' claims. This would include acts that involve self-dealing or the preferential treatment of creditors. Cases applying the trust-fund doctrine appear to have dealt with actually insolvent entities, and because the existence of a zone or vicinity of insolvency is even less objectively determinable than actual insolvency, there is no fiduciary duty prescribed under California law that is owed to creditors by directors of a corporation solely by virtue of its operating in the zone or vicinity of insolvency.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Business Judgment Rule

HN8[] Fiduciary Duties, Business Judgment Rule

The business judgment rule has been codified in Corp. Code, § 309. But the common law rule has two components--one which immunizes directors from personal liability if they act in accordance with its requirements, and another which insulates from court intervention those management decisions which are made by directors in good faith in what the directors believe is the organization's best interest. Only the first component is embodied in § 309. The broader rule is a judicial policy of deference to the business judgment of corporate directors in the exercise of their broad discretion in making corporate decisions. It is based on the premise that those to whom the management of a business organization has been entrusted, and not the courts, are best able to judge whether a particular act or transaction is helpful to the conduct of the organization's affairs or expedient for the attainment of its purposes. The rule establishes a presumption that directors' decisions are based on sound business judgment, and it prohibits courts from interfering in business decisions made by the directors in good faith and in the absence of a conflict of interest. A hallmark of the business judgment rule is that a court will not substitute its judgment for that of the board if the latter's decision can be attributed to any rational business purpose.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Business Judgment Rule

HN9[] **Fiduciary Duties, Business Judgment Rule**

An exception to the presumption afforded by the business judgment rule exists in circumstances which inherently raise an inference of conflict of interest, and the rule does not shield actions taken without reasonable inquiry, with improper motives, or as a result of a conflict of interest. But a plaintiff must allege sufficient facts to establish these exceptions. To do so, more is needed than conclusory allegations of improper motives and conflict of interest. Neither is it sufficient to generally allege the failure to conduct an active investigation, in the absence of (1) allegations of facts which would reasonably call for such an investigation, or (2) allegations of facts which would have been discovered by a reasonable investigation and would have been material to the questioned exercise of business judgment. In most cases, the presumption created by the business judgment rule can be rebutted only by affirmative allegations of facts which, if proven, would establish fraud, bad faith, overreaching or an unreasonable failure to investigate material facts. Interference with the discretion of directors is not warranted in doubtful cases.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Business Judgment Rule

Civil Procedure > ... > Responses > Defenses, Demurrers & Objections > Demurrers

HN10[] **Fiduciary Duties, Business Judgment Rule**

A failure to sufficiently plead facts to rebut the business judgment rule or establish its exceptions may be raised on demurrer, as whether sufficient facts have been so pleaded is a question of law.

Civil Procedure > ... > Pleadings > Amendment of Pleadings > Leave of Court

HN11[] **Amendment of Pleadings, Leave of Court**

Under the sham pleading doctrine, courts are free to disregard inconsistent allegations offered for amendment.

Headnotes/Summary

Summary

CALIFORNIA OFFICIAL REPORTS SUMMARY

The trial court sustained, without leave to amend, corporate directors' demurrers to a creditor's complaint alleging breach of fiduciary duty. The corporation entered into an assignment for the benefit of creditors. The complaint alleged that the directors had failed to investigate the possibility of a bankruptcy reorganization through which the corporation's accumulated net operating losses might have been carried forward. (Superior Court of Santa Clara County, No. CV044686, Neal Anthony Cabrinha, Judge.)

The Court of Appeal affirmed, holding that no duty arises from operating in the zone or vicinity of insolvency and that the scope of any extracontractual duty owed by directors of an insolvent corporation to creditors under *Corp. Code, § 309, subd. (a)*, is limited under the trust fund doctrine to avoiding actions that would divert, dissipate, or unduly risk corporate assets that might otherwise be used to pay creditors' claims, including self-dealing or preferential treatment of creditors. Thus, the pleading failed to state a claim because such actions were not alleged. The court further held that the pleading failed to allege sufficient facts to avoid the application of the business judgment rule under § 309 and the common law because the creditor did not allege facts establishing that a reorganization reasonably could have been implemented. Leave to amend was properly denied because the creditor's proposed new facts did not cure the defects. (Opinion by Duffy, J., with Mihara, Acting P. J., and McAdams, J., concurring.) **[*1021]**

Headnotes

CALIFORNIA OFFICIAL REPORTS HEADNOTES

CA(1)[] **(1)**

Pleading § 21—Demurrer to Complaint—Successive Demurrers.

Where a prior demurrer has been sustained as to some causes of action but overruled as to others, case law has held that a defendant may not demur again on the same grounds to those portions of an amended pleading as to which the prior demurrer was overruled. But where there is only one cause of action and the prior demurrers to that cause of action were sustained, this is a critical difference. And when a plaintiff files an amended pleading in response to an order sustaining a prior demurrer to a cause of action with leave to amend, the amended cause of action is treated as a new pleading and a defendant is free to respond to it by demurrer on any ground. Accordingly, where defendants have demurred to a single cause of action of an amended complaint as to which no prior demurrer has been overruled, the restrictive provisions of Code Civ. Proc., § 1008, are inapplicable. Moreover, there has been some case law concluding that a party is within its rights to successively demur to a cause of action in an amended pleading notwithstanding a prior unsuccessful demurrer to that same cause of action.

CA(2)[] **(2)**

Corporations § 35—Directors—Fiduciary Relationship—Honesty, Loyalty, and Good Faith.

In California, corporate directors owe a fiduciary duty to the corporation and its shareholders and, as set out by statute, must serve in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders (Corp. Code, § 309, subd. (a)). This duty—generally to act with honesty, loyalty, and good faith—derives from the common law.

CA(3)[] **(3)**

Corporations § 35—Directors—Fiduciary Relationship—Duty to Creditors upon Insolvency—Trust Fund Doctrine.

California case law has applied the trust fund doctrine where all of the assets of a corporation, immediately on its becoming insolvent, become a trust fund for the benefit of all of its creditors in order to satisfy their claims. Recovery for breaching the fiduciary duties imposed under the trust fund doctrine in California generally pertains to cases where the directors or officers of an insolvent corporation have diverted assets of the corporation for the benefit of insiders or preferred creditors. While no California cases expressly limit the fiduciary duty under the trust fund doctrine to the prohibition of self-dealing or the preferential treatment of creditors, the scope of the trust fund doctrine in California is reasonably limited to cases where directors or officers have diverted, dissipated, or unduly risked the insolvent corporation's assets. In other words, the doctrine is not applied to create a duty owed by directors to creditors solely due to a state of corporate insolvency. Application of the doctrine requires, in **[*1022]** addition, that directors have engaged in conduct that diverted, dissipated, or unduly risked corporate assets that might otherwise have been used to satisfy creditors' claims.

CA(4)[] **(4)**

Corporations § 35—Directors—Fiduciary Relationship—Duty to Creditors upon Insolvency—Trust Fund Doctrine.

There is no broad, paramount fiduciary duty of due care or loyalty that directors of an insolvent corporation owe the corporation's creditors solely because of a state of insolvency. Any such duty would conflict with and dilute the statutory and common law duties that directors already owe to shareholders and the corporation. There would be practical problems with creating such a duty, among them a director's ability to objectively and concretely determine when a state of insolvency actually exists such that his or her duties to creditors have been triggered. Accordingly, the scope of any extracontractual duty owed by corporate directors to the insolvent corporation's creditors is limited in California, consistent with the trust fund doctrine, to the avoidance of actions that divert, dissipate, or unduly risk corporate assets that might otherwise be used to pay creditors' claims. This would include acts that involve self-dealing or the preferential treatment of creditors. Cases applying the trust fund doctrine appear to have dealt with actually insolvent entities, and because the existence of a zone or vicinity of insolvency is even less objectively determinable than actual insolvency, there is no fiduciary duty prescribed under California law that is owed to creditors by directors of a corporation solely by virtue of its operating in the zone or vicinity of insolvency.

CA(5)[] **(5)**

Corporations § 35—Directors—Fiduciary Relationship—Duty to Creditors upon Insolvency—Trust Fund Doctrine—Failure to State Cognizable Claim.

Applying the scope of duty defined by the trust fund doctrine, and according truth to the well-pleaded facts of a creditor's complaint, the pleading failed to state facts constituting a cognizable claim for breach of fiduciary duty. Assuming a state of actual insolvency, the thrust of the creditor's claim was that the directors effected an assignment for the benefit of creditors, a recognized statutory alternative to liquidation through bankruptcy, rather than investigating, exploring or pursuing a bankruptcy reorganization through which the creditor theoretically could have maximized the value of the corporation's accumulated net operating losses and the other creditors could have benefited. These facts did not involve self-dealing or prohibited preferential treatment of creditors and further did not constitute the actual diversion, dissipation, or undue risking of corporate assets that were otherwise available to pay creditors' claims. Moreover, the creditor did not plead facts that identified sources of funds or financing through which the corporation could have continued to operate even in bankruptcy; and it **[*1023]** did not plead facts alleging how the carry-forward of the corporation's accumulated net operating losses through bankruptcy could have been actually used to pay or satisfy creditors' claims—the operative standard.

[*Ballantine & Sterling, Cal. Corporation Laws (4th ed. 2009) ch. 6, § 101*; *Cal. Forms of Pleading and Practice (2009) ch. 167, Corporations: Directors and Management, § 167.51*; 9 Witkin, Summary of Cal. Law (10th ed. 2005) Corporations, §§ 100A, 102.]

CA(6)[] **(6)**

Corporations § 39—Directors—Liability—Business Judgment Rule.

The business judgment rule has been codified in *Corp. Code, § 309*. But the common law rule has two components—one which immunizes directors from personal liability if they act in accordance with its requirements, and another which insulates from court intervention those management decisions which are made by directors in good faith in what the directors believe is the organization's best interest. Only the first component is embodied in *§ 309*. The broader rule is a judicial policy of deference to the business judgment of corporate directors in the exercise of their broad discretion in making corporate decisions. It is based on the premise that those to whom the management of a business organization has been entrusted, and not the courts, are best able to judge whether a particular act or transaction is helpful to the conduct of the organization's affairs or expedient for the attainment of its purposes. The rule establishes a presumption that directors' decisions are based on sound business judgment, and it prohibits courts from interfering in business decisions made by the directors in good faith and in the absence of a conflict of interest. A hallmark of the business judgment rule is that a court will not substitute its judgment for that of the board if the latter's decision can be attributed to any rational business purpose.

CA(7)[] **(7)**

Corporations § 39—Directors—Liability—Business Judgment Rule.

An exception to the presumption afforded by the business judgment rule exists in circumstances which inherently raise an inference of conflict of interest, and the rule does not shield actions taken without reasonable inquiry, with improper motives, or as a result of a conflict of interest. But a plaintiff must allege sufficient facts to establish these exceptions. To do so, more is needed than conclusory allegations of improper motives and conflict of interest. Neither is it sufficient to generally allege the failure to conduct an active investigation, in the absence of (1) allegations of facts which would reasonably call for such an investigation, or (2) allegations of facts which would have been discovered by a reasonable investigation and would have been material to the questioned exercise of business judgment. In most cases, the presumption created by the business judgment rule can be rebutted only **[*1024]** by affirmative allegations of facts which, if proven, would establish fraud, bad faith, overreaching or an unreasonable failure to investigate material facts. Interference with the discretion of directors is not warranted in doubtful cases.

CA(8)[] **(8)**

Corporations § 39—Directors—Liability—Business Judgment Rule—Ground for Demurrer.

A failure to sufficiently plead facts to rebut the business judgment rule or establish its exceptions may be raised on demurrer, as whether sufficient facts have been so pleaded is a question of law.

CA(9)[] **(9)**

Pleading § 67—Amendment—By Leave of Court—Sham Pleading Doctrine.

Under the sham pleading doctrine, courts are free to disregard inconsistent allegations offered for amendment.

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Winston & Strawn, Robert A. Julian and Nicole P. Dogwill for Defendant and Respondent John Boyle.

O'Melveny & Myers, Meredith N. Landy, Lori E. Romley and Sara M. Folchi for Defendants and Respondents David Britts, Tony Daffer, Barry Eggers, Diana Everett, John Gerdelman, Cliff Higgerson, Joseph Kennedy and Bob Williams.

Judges: Opinion by Duffy, J., with Mihara, Acting P. J., and McAdams, J., concurring.

Opinion by: Duffy

Opinion

[880]** **DUFFY, J.**?Appellant Berg & Berg Enterprises, LLC, the largest creditor of the failed Pluris, Inc., challenges the trial court's sustaining, without leave to amend, respondents' demurrers to Berg's third amended complaint. Respondents were individual members of Pluris's board of directors. After **[*1025]** they challenged Berg's prior pleadings by successful demurrers and an anti-SLAPP (strategic lawsuit against public participation) motion, Berg's operative pleading alleged a single cause of action for breach of fiduciary duty. Pluris had experienced financial difficulties and had as a result entered into an assignment for the benefit of creditors under *Code of Civil Procedure sections 493.010* and *1802*. [1] The thrust of Berg's claim, as finally pleaded, was that the individual directors **[***2]** owed a fiduciary duty to Berg and other Pluris creditors on whose behalf Berg is purportedly proceeding. The duty allegedly arose when Pluris either became insolvent or entered into the "zone of insolvency" at some point before the assignment. The directors allegedly breached that duty by electing to make the assignment, thereby extinguishing Berg's plan to use the corporation's alleged $ 50 million of **[**881]** net operating losses through a chapter 11 bankruptcy reorganization that, according to Berg, would have benefitted it and the other creditors by deriving value from the losses. Berg alleged that the directors had failed to conduct a reasonable investigation into its proposed plan before proceeding with the assignment and had they investigated, they would have seen that pursuing Berg's bankruptcy plan was the only viable way to protect, and thereby satisfy their fiduciary duty to, Pluris's creditors. [2]

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[1] An assignment for the benefit of creditors is a recognized but less than comprehensive statutory procedure that is an alternative to liquidation in bankruptcy. (*Code Civ. Proc., §§ 493.010* & *1802*; *Berg & Berg Enterprises, LLP v. Sherwood Partners, Inc. (2005) 131 Cal.App.4th 802, 829, fn. 13 [32 Cal.Rptr.3d 325]*; **[***3]** *Sherwood Partners, Inc. v. EOP-Marina Business Center, L.L.C. (2007) 153 Cal.App.4th 977, 981–982 [62 Cal. Rptr. 3d 896]*; 1 Witkin, Summary of Cal. Law (10th ed. 2005) Contracts, §§ 710 & 711, pp. 795–798.)

[2] In a previous separate but related action, Berg also sued the

We conclude that Berg failed to plead a cognizable claim for breach of fiduciary duty against the individual directors. And even **[***4]** if a cognizable claim had been alleged, on the pleaded facts the business judgment rule insulated the directors from personal liability on the alleged claims for breach of fiduciary duty as a matter of law. We accordingly affirm the judgment of dismissal.

[*1026]

STATEMENT OF THE CASE

I. *Prior Pleadings and the Trial Court's Rulings on Challenges Thereto* [3]

Berg's initial complaint, on which it proceeded directly on its sole behalf (as opposed to derivatively), named as defendants the respondents here—John Boyle, David Britts, Tony Daffer, Barry Eggers, Diana Everett, John Gerdelman, Cliff Higgerson, Joseph Kennedy, and Bob Williams—all members of Pluris's board of directors at some point. The pleading alleged a single cause of action for breach of fiduciary duty. Underlying the claim was the allegation that at all relevant times, **[***5]** Pluris was operating "in a zone of insolvency" during which its board of directors owed its creditors a fiduciary duty. This alleged duty included "the obligation not just to protect the assets of PLURIS but to affirmatively examine a range of possible courses of action to maximize the value of its remaining assets, not merely to take the course of action most expedient to [the individual directors] and make an Assignment [for the benefit of creditors]." This duty was alleged to have been primarily breached by the directors' having "fail[ed] to explore whether BERG's proposed reorganization [in bankruptcy] would or might have yielded greater assets [than the assignment] for [Pluris's] creditors."

The pleading also alleged as background that some six months before the assignment for the benefit of creditors in July 2002, Pluris and a Berg-related entity had entered into a settlement that liquidated and partially secured what came to be Berg's claim by assignment, and allowed Pluris to seek additional outside financing. In conjunction with the settlement, Berg's **[**882]** principal, Carl Berg, allegedly informed the Pluris directors that if the financing effort failed, Berg "would want to explore **[***6]** ways to derive value from PLURIS beyond the obvious hard and soft assets, including the possibility of obtaining value from the millions of dollars in net operating losses … PLURIS ha[d] accumulated. To obtain that value, PLURIS would need to be reorganized under the bankruptcy laws." [4] The pleading further alleged that it was not until after the assignment—during the course of later involuntary bankruptcy proceedings initiated by Berg and two other creditors—that Carl Berg offered the details of his plan to use the company's net operating losses. These details included **[*1027]** that through a bankruptcy reorganization (1) Berg would make a $ 150,000 cash contribution to Pluris for the benefit of its unsecured creditors; (2) Berg would reduce the unsecured portion of its claim by $ 1.5 million in consideration for 100 percent of the stock in the reorganized entity plus the assignment of all claims or causes of action that Pluris had the right to pursue; and (3) Berg would further reduce its unsecured claim by $ 2.5 million in consideration for all of Pluris's noncash assets, including its intellectual property, software, and inventory. All told, the pleading alleged, these plan details **[***7]** would result in the reduction of Berg's unsecured claim by $ 4 million plus its infusion of $ 150,000 for the benefit of other unsecured creditors. The import of these background allegations of the initial complaint as relevant here was that they alleged that it was only *after*

assignee for the benefit of creditors, Sherwood Partners, Inc., and its counsel, SulmeyerKupetz, alleging, among other claims, an attorney-client conspiracy to deplete Pluris's assets by generating and paying from them unconscionable attorney fees. Concluding that Berg had failed to plead a viable conspiracy claim against a party and its lawyers and further that the assignee's counsel owed no independent fiduciary duty to Pluris's creditors, we rejected Berg's claims in *Berg & Berg Enterprises, LLC v. Sherwood Partners, Inc., supra, 131 Cal.App.4th 802*. On remand, the case apparently settled, with Sherwood assigning whatever claims it had against the individual Pluris directors to Berg, or so Berg alleged below. We express no opinion on the validity of any such assignment and we need not do so in light of our opinion.

[3] While only the third amended complaint as the operative pleading is directly relevant to our review of the judgment, we briefly discuss the pleading history as certain prior allegations and court rulings bear on the issues pertinent to that review. We more thoroughly relay the pleaded background facts in conjunction with our discussion of the third amended complaint.

[4] As observed by defendant Boyle at oral argument, Berg references no authority for the proposition that Pluris was required to proceed in bankruptcy in order to use the net operating losses in the manner proposed by Berg because it could not do so through an assignment for the benefit of creditors. For our purposes, we accept as true Berg's allegation that a bankruptcy proceeding was required in order to implement its plan.

the assignment for the benefit of creditors had been made and "during" later involuntary bankruptcy proceedings that Berg provided the details of its plan to use Pluris's net operating losses.

Apparently before any responsive pleadings were filed, Berg filed a first amended complaint. The new pleading restated the breach-of-fiduciary-duty claim and added two causes of action for fraudulent and negligent misrepresentation, respectively. It reiterated that before the assignment, Berg had only **[***8]** generally informed Pluris's directors of his desire to explore the use of Pluris's net operating losses through a petition in bankruptcy if Pluris's outside financing efforts failed and that it was only later, during involuntary bankruptcy proceedings, that Berg provided the details of this plan.

Defendant John Boyle demurred to the amended pleading on various grounds. The other directors likewise demurred and some filed an anti-SLAPP motion (under *Code Civ. Proc., § 425.16*) to the new misrepresentation causes of action, which the other defendants joined. In the face of the anti-SLAPP motion, Berg voluntarily dismissed its two misrepresentation causes of action leaving only its claim for breach of fiduciary duty as the target of the demurrers. [5] The court (Judge C. Randall Schneider) sustained the demurrers with leave to amend. The basis of the order was, in essence, lack of standing—Berg's claim of injury was not unique to itself or to a particular class of creditors but rather incidental to injury that all of Pluris's creditors might have suffered as a result of the assignment for **[**883]** the benefit of creditors. Therefore, the claim was not direct and particular to Berg but rather derivative **[***9]** and assertable only on behalf of all of Pluris's creditors. [6] The court further noted that in light of its dispositive ruling, it need not directly address **[*1028]** another ground raised by demurrer—that the Pluris directors were insulated from liability by the business judgment rule. But, "for the guidance of the parties," the court nevertheless observed that particular allegations of the first amended complaint appeared "sufficient to rebut the business judgment presumption."

Berg filed a second amended complaint, this time on "behalf of [itself] and all other Pluris, Inc. creditors," consistent with the court's prior ruling. The new pleading in substance restated the allegations of Berg's previously asserted breach-of-fiduciary-duty claim, including that before the assignment for the benefit of creditors, Berg had informed Pluris of its desire to explore use of Pluris's net operating losses through bankruptcy in the event Pluris could not obtain outside financing but after the assignment and during later involuntary bankruptcy proceedings, Berg provided details of this plan.

The directors demurred to Berg's second amended complaint on numerous grounds. The court (Judge Neal A. Cabrinha) determined that while the pleading could be "reasonably be interpreted as alleging **[***11]** a creditors' claim under common law," Berg had failed to allege specific facts to rebut the business judgment rule—"affirmative allegations of facts which, if proven, would establish fraud, bad faith, overreaching, or an unreasonable failure to investigate material facts"—and thus had not stated a viable claim for breach of fiduciary duty. The court ruled that Berg's allegations that the directors did not conduct a "reasonable inquiry into alternative methods of financing or alternative ways to derive additional value in Pluris for its creditors, but instead took the easiest path for themselves and assigned all of Pluris's assets to an assignee" did not establish "that [the] defendants acted with an improper motive and a conflict of interest. … [¶] … [¶] At first blush, the allegation that defendants did not explore alternative avenues of financing or alternative ways to derive additional value in Pluris for its creditors pleads around the business judgment rule. However, it is not sufficient to generally allege the failure to conduct an active investigation without (1) alleging facts which would reasonably call for such an investigation, or (2) alleging facts which would **[***12]** have been discovered by a reasonable investigation and would

[5] The court nevertheless concluded that the anti-SLAPP motion was well taken and later awarded defendants statutory attorney fees per this determination.

[6] "An action is derivative, that is, in the corporate right, '"if the gravamen of the complaint is injury to the corporation, or to the whole body of its stock and property without any severance or distribution among individual holders, or it seeks to recover assets for the corporation or to prevent the dissipation of its assets." ' (*Jones [v. H. F. Ahmanson & Co. (1969) 1 Cal.3d 93, 106 [81 Cal. Rptr. 592, 460 P.2d 464]]*.)" (*Everest Investors 8 v. McNeil Partners (2003) 114 Cal.App.4th 411, 425 [8 Cal. Rptr. 3d 31]*.) On the other hand, a creditor's individual or direct claim is one for which the creditor does not seek to recover **[***10]** on behalf of the corporation for injury done to it. The injury need not be different from that suffered by a class of shareholders or be unique to the plaintiff and it still may affect a substantial number of shareholders or in this case, creditors. But the direct claim is simply one that reflects an injury that is not incidental to an injury to the corporation as a whole. (*Id. at pp. 425–428*.)

have been material to the questioned exercise of business judgment. … [¶] … The Second Amended Complaint does not allege facts establishing the existence of any alternative methods of financing or means to increase the **[*1029]** value of Pluris's assets for the benefit of creditors **[**884]** generally. As a result, it fails to establish a breach of fiduciary duty."

Thus, the court determined that because Berg had failed to plead specific facts to rebut the presumption of nonliability afforded by the business judgment rule, it had failed to adequately plead a cognizable claim for breach of fiduciary duty against the directors. As a result, the court sustained the demurrers with leave to amend.

II. *Berg's Third Amended Complaint*

This brings us to the operative pleading—Berg's third amended complaint. [7] In it, Berg, for itself and purportedly on behalf of all Pluris creditors, restated its single cause of action for breach of fiduciary duty against the Pluris directors. [8] The pleading alleged in conclusory fashion and without supporting facts that "[a]t least from January 2002, and continuing thereafter, PLURIS was either insolvent or operating **[***13]** within the 'zone of insolvency.' During this time, PLURIS's Board of Directors and each director individually owed a fiduciary duty to act for the benefit of PLURIS's creditors." That duty, as alleged, included "the obligation not just to protect the assets of PLURIS but to affirmatively examine a range of possible courses of action to maximize the value of the remaining assets, not merely to take the course of action most expedient to [the directors] and make an Assignment."

As background, the pleading, like its superseded predecessors, went on to allege that in 2001, one of Pluris's creditors was a Berg-related entity that had entered into a lease with Pluris, which Pluris repudiated, resulting in litigation. That dispute was settled in February 2002 when Pluris informed Berg's principal, Carl Berg, that it was attempting to obtain outside financing to continue operations and that settlement of Berg's claim was a condition to receiving that financing. In the course **[***14]** of these discussions, Carl Berg then informed Pluris, allegedly through its board of directors, that if its financing efforts failed, the Berg-related entity or its assignee "wanted to derive value" or "want[ed] to explore ways to derive additional value" from the $ 50 million in net operating losses that Pluris had accumulated and that one of Berg's plans for doing so required a reorganization of Pluris through federal bankruptcy laws. [9] The settlement between Pluris and the Berg-related entity **[*1030]** liquidated and partially secured the claim, which was then assigned to Berg making it Pluris's largest creditor.

Pluris's efforts to obtain outside financing did not result in its getting sufficient funds to continue operations, as a result of which, on July 11, 2002, Pluris, through its board of directors, made an assignment for the benefit of creditors. According to Berg, in doing so, the directors "failed, refused or neglected to seek or to find any alternative financing or to make a reasonable inquiry into alternative financing even though they knew or reasonably should **[**885]** have known there were a number of potential sources available." The board also "failed to make any reasonable inquiry into alternative ways to derive additional value for the PLURIS creditors other than making an assignment for the benefit of creditors … despite the fact that [the directors] were specifically advised there were alternatives that might generate greater value. For example, [Carl] Berg [had] explained [that] if Pluris w[ere] unsuccessful [at obtaining sufficient outside financing], he intended **[***16]** to seek [to benefit from] the value of PLURIS's $ 50 million [in net operating losses through] a bankruptcy reorganization. Pursuant to the reorganization, there would [be] additional benefits to creditors such as [those] incorporated in the proposed Berg plan." These benefits included the same reduction of Berg's unsecured claim and a cash contribution to the bankruptcy estate of $ 150,000 for the benefit of other unsecured creditors that we noted from prior pleadings. [10] But, Berg further alleged, "[r]ather than exploring

[7] We include here only seemingly relevant facts alleged in the 17-page pleading containing a single cause of action.

[8] For the first time, Berg also named Pluris as a defendant, but this is not relevant to the issues on appeal.

[9] This is a bit different from prior pleadings, which had alleged that at this point in time, Berg had only expressed a general desire to "explore" ways to derive value from Pluris's net operating losses, an allegation that is also included in the third amended complaint. As Berg's counsel later explained, in order to "derive value" from Pluris's net operating losses according to Berg's plan, the corporation had to reorganize through a bankruptcy proceeding and allow Carl Berg "to **[***15]** put a skeleton staff together, run it for a period of time, and take advantage of the net operating losses." Just how this activity by Pluris as a separate business entity could inure to Berg's benefit is not exactly clear.

[10] These were the plan details that prior pleadings had alleged

alternative forms of financing, including Berg's plans, … the Directors took the easiest path for themselves, and made an assignment of all PLURIS's assets to an assignee for the alleged benefit of creditors, and then 'washed their hands' of the matter." Said yet another way, the directors, as shareholders, "[h]aving determined that their own investment in PLURIS essentially had no value, they looked no further and ignored their continuing duties to the PLURIS creditors by, among other things, refusing to examine alternatives which were specifically brought to their attention or to explore other options, all of which would have enhanced the value to the PLURIS **[***17]** creditors. Instead, they assigned PLURIS's assets to an assignee, and walked away." Berg still further alleged that the directors "did not explore and had no intention of exploring alternative avenues of financing or ways to maximize PLURIS's assets, but instead chose to 'cut **[*1031]** their losses'" by the assignment "without any reasonable inquiry concerning other ways to protect the interests of Berg and the other creditors, despite that several possible alternatives had specifically been brought to their attention by Berg, and other possible alternatives might have been found with modest inquiry."

The pleading then alleged that from the date of the assignment in July 2002 until August 16, 2002, when Berg and two other Pluris creditors filed **[***18]** an involuntary petition in bankruptcy on its behalf, Berg "tried unsuccessfully to contact PLURIS's BOARD OF DIRECTORS" and no member of the board contacted Berg "to explore … identifying alternative ways to achieve greater value in PLURIS. Nor did any [director] conduct [a] reasonable inquiry to determine how to protect or enhance the value of PLURIS [or how] to protect BERG's interests, including an inquiry concerning BERG's ability to use PLURIS's [net operating losses]. [¶] … At no time between January 2002 and the Assignment … did PLURIS's BOARD OF DIRECTORS ever examine means to increase the value of PLURIS's assets for the benefit of creditors generally other than by making an Assignment … .?

In the penultimate allegations of the cause of action as relevant here, Berg pleaded that the directors had breached their fiduciary duties by selecting a course **[**886]** of action that was "easiest for them by ignoring alternatives specifically brought to their attention, including BERG's proposed reorganization[,] and [by] failing to make any reasonable inquiry into other possible approaches that would or might have yielded greater assets for the creditors"; and by failing "to explore **[***19]** BERG's articulated plan to maximize the value of PLURIS's [net operating losses for] the benefit [of] creditors." [11]

The pleading further alleged that "[o]n August 16, 2002, in order to protect their interests and the interests of other creditors, three of PLURIS's creditors, including BERG, filed an involuntary petition for bankruptcy [under *11 U.S.C § 303*] concerning PLURIS's estate. During the bankruptcy proceeding, Berg continued to offer his plans for [Pluris's] reorganization." [12] In January 2003, at the request of Sherwood, the assignee, the bankruptcy court **[*1032]** abstained from exercising jurisdiction under title *11 United States Code section 305(a)(1)* and dismissed the involuntary petition. [13]

The third amended complaint finally alleged that as a proximate result of the directors' breach of fiduciary duty, which Berg alleged to be willful, malicious, and oppressive so as to justify an award of punitive damages, Berg and the other Pluris creditors were damaged in a sum "in excess of $ 50 million which includes, but is not limited to, the loss of use of PLURIS's [net operating losses]."

III. *The Directors' Demurrers and the Trial Court's Ruling*

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were first proposed by Berg only later, during involuntary bankruptcy proceedings. The third amended complaint alleges, inconsistently with those prior pleadings, that during the involuntary bankruptcy proceedings, Carl Berg "*continued* to offer his plans for reorganization," as if the plan details, or some of them, had been previously put forth before the July 2002 assignment. (Italics added.)

[11] Berg also pleaded as part of these allegations that the directors had breached their duty by prohibiting Berg from timely using or otherwise disposing of Pluris's assets that secured its obligation to Berg, and, without reference to any specific facts, by "using the remaining PLURIS assets for themselves." But Berg did not pursue these particular allegations below and does not pursue them here. Any claim regarding them has accordingly been forfeited or waived.

[12] See footnote 10, **[***20]** *ante*.

[13] The primary bases of the court's order were that creditors and the debtor would be ?better served" by a dismissal of the involuntary petition because Pluris, as a "non-operating company" with "no employees, no ongoing business activities, no accounts receivables or any other source of revenue, and no customers" had already entered into an assignment for the benefit of creditors through which it was being liquidated, not reorganized, and because Carl Berg was not motivated to ensure a fair distribution to Pluris's creditors but rather to gain "control of Pluris and its assets for his potential advantage," which the court viewed as "self serving."

The directors all demurred to the third amended complaint for its failure to state facts **[***21]** sufficient to constitute a cause of action, reprising many arguments they had raised in previous pleading challenges. On December 21, 2006, the court (Judge Neal A. Cabrinha) issued its order sustaining the demurrers without leave to amend. The court's rationale was that the third amended complaint failed to allege a viable claim for breach of fiduciary duty against the directors. The court relied on *CarrAmerica Realty Corp. v. nVIDIA Corp. (N.D.Cal., Sept. 29, 2006, No. C 05-00428 JW) 2006 U.S.Dist. Lexis 75399* (*CarrAmerica*), a recent federal Northern District of California case that had not been cited by the parties in their papers.

According to the court, *CarrAmerica* determined that California follows the "'trust fund doctrine'" with respect to duties owed by corporate directors to creditors that arise upon the corporation's insolvency. The scope of this duty is to avoid "'divert[ing], dissipat[ing] or unduly risk[ing] assets necessary to satisfy'" **[**887]** creditors' claims. The court observed that because this duty can be characterized as the obligation to avoid the squandering of an insolvent corporation's assets, "recovery for breach of this fiduciary duty generally concerns cases [in which] **[***22]** the directors of an insolvent corporation improperly divert corporate assets. [Citations.] Although no California cases expressly limit the 'fiduciary duty under the trust fund doctrine to the prohibition of self-dealing or the preferential treatment of creditors, the scope of the trust fund doctrine in California is reasonably limited to cases [in which] directors or officers have diverted, dissipated, or unduly risked the insolvent corporation's assets.' [Citation.]" **[*1033]**

The court noted that the third amended complaint did not meet this standard as it did not allege that the Pluris directors "improperly assigned assets for their own interests, or assigned assets knowing the assignee would breach its fiduciary duty to the creditors." Instead, the pleading alleged only that the directors had failed "to explore a plan suggested by [Berg] that may have made better use of the assets. … [Berg's] allegations relating to the conduct of the assignee are irrelevant absent an allegation that the directors were aware that the assignee was unscrupulous or that the directors have an interest in the assignee." The court concluded that because Berg "cannot allege defendants breached their duty not **[***23]** to 'divert, dissipate or unduly risk assets' by [having assigned] the assets for the benefit of [Pluris's] creditors, the demurrers are sustained without leave to amend."

Berg moved for reconsideration of the order under *Code of Civil Procedure section 1008*, citing *CarrAmerica* as new law and asserting that its claim was not based on the directors' failure to make the best use of Pluris's assets as the court had concluded but rather on their having "knowingly squandered Pluris['s] largest asset"—its net operating losses. This breach of duty, it argued, fell squarely within the parameters of a permissible breach-of-fiduciary-duty claim as defined in *CarrAmerica*—the diversion, dissipation, or undue risking of assets. Moreover, Berg contended, it could plead additional facts to state such a claim as set out in the court's order, namely that the directors had used a "portion of [Pluris's] remaining cash to pay preferred creditors (employee severance payments made days before the assignment)" and that after the assignment, Berg contacted the directors, "reminded them of his plan, complained about the unscrupulous acts of the assignee, and was ignored."

Over defendants' opposition, the court **[***24]** granted reconsideration of its prior order because the court had relied on *CarrAmerica*—a case not initially cited or briefed by the parties. Upon reconsideration, the court affirmed its prior order sustaining the demurrers to Berg's third amended complaint without leave to amend.

Judgment of dismissal was entered on May 7, 2007, and Berg's timely notice of appeal followed.

DISCUSSION

I. *Berg's Contentions on Appeal and Standard of Review*

Berg's overarching contention on appeal is that the trial court erred in sustaining the demurrers to its third amended complaint because Berg had stated a viable claim for breach of fiduciary duty and had pleaded facts to **[*1034]** rebut the business judgment rule. Its subsidiary contentions include that the court lacked the power to determine that a claim for breach of fiduciary duty against the directors had not been stated in light of prior demurrer rulings and that Berg should have been **[**888]** granted leave to file a fourth amended complaint.

HN1[] "A demurrer tests the sufficiency of the complaint as a matter of law; as such, it raises only a question of law. [Citations.]" (*Osornio v. Weingarten (2004) 124 Cal.App.4th 304, 316 [21 Cal. Rptr. 3d 246]*.) Thus, the standard of review on appeal is **[***25]** de novo. (*Cryolife, Inc. v. Superior Court (2003) 110 Cal.App.4th 1145, 1152 [2 Cal. Rptr. 3d 396]*.) "In reviewing the sufficiency of a complaint against a general demurrer, we are guided by long-settled rules. 'We treat the demurrer as admitting all material facts properly pleaded, but not contentions, deductions or conclusions of fact or law. [Citation.] We also consider matters which may be judicially noticed.' [Citation.] Further, we give the complaint a reasonable interpretation, reading it as a whole and its parts in their context. [Citation.] When a demurrer is sustained, we determine whether the complaint states facts sufficient to constitute a cause of action. [Citation.]" (*Blank v. Kirwan (1985) 39 Cal.3d 311, 318 [216 Cal. Rptr. 718, 703 P.2d 58]*; see also *Evans v. City of Berkeley (2006) 38 Cal.4th 1, 5 [40 Cal. Rptr. 3d 205, 129 P.3d 394]*; *SC Manufactured Homes, Inc. v. Liebert (2008) 162 Cal.App.4th 68, 82 [76 Cal. Rptr. 3d 73]*.) Where, as here, a demurrer is to an amended complaint, we may consider the factual allegations of prior complaints, which a plaintiff may not discard or avoid by making ""“contradictory averments, in a superseding, amended pleading.”"" (*People ex rel. Gallegos v. Pacific Lumber Co. (2008) 158 Cal.App.4th 950, 957 [70 Cal. Rptr. 3d 501]*.)

“It is not the ordinary function of a demurrer **[***26]** to test the truth of the plaintiff's allegations or the accuracy with which he describes the defendant's conduct. A demurrer tests only the legal sufficiency of the pleading.” (*Committee on Children's Television, Inc. v. General Foods Corp. (1983) 35 Cal.3d 197, 213 [197 Cal. Rptr. 783, 673 P.2d 660]*.) Thus, as noted, in considering the merits of a demurrer, “the facts alleged in the pleading are deemed to be true, however improbable they may be. [Citation.]” (*Del E. Webb Corp. v. Structural Materials Co. (1981) 123 Cal.App.3d 593, 604 [176 Cal. Rptr. 824]*; see also *Alcorn v. Anbro Engineering, Inc. (1970) 2 Cal.3d 493, 496 [86 Cal. Rptr. 88, 468 P.2d 216]* [court reviewing propriety of ruling on demurrer not concerned with the “plaintiff's ability to prove … allegations, or the possible difficulty of making such proof”].)

HN2[] On appeal, we will affirm a “trial court's decision to sustain the demurrer [if it] was correct on any theory. [Citation.]” (*Kennedy v. Baxter Healthcare Corp. (1996) 43 Cal.App.4th 799, 808 [50 Cal. Rptr. 2d 736]*, fn. omitted.) Accordingly, “we do not review the validity of the trial court's reasoning but **[*1035]** only the propriety of the ruling itself. [Citations.]” (*Orange Unified School Dist. v. Rancho Santiago Community College Dist. (1997) 54 Cal.App.4th 750, 757 [62 Cal. Rptr. 2d 778]*.)

HN3[] Where a **[***27]** demurrer is sustained without leave to amend, the reviewing court must determine whether there is a reasonable probability that the complaint could have been amended to cure the defect; if so, it will conclude that the trial court abused its discretion by denying the plaintiff leave to amend. (*Williams v. Housing Authority of Los Angeles (2004) 121 Cal.App.4th 708, 719 [17 Cal. Rptr. 3d 374]*.) The plaintiff bears the burden of establishing that it could have amended the complaint to cure the defect. (*Campbell v. Regents of University of California (2005) 35 Cal.4th 311, 320 [25 Cal. Rptr. 3d 320, 106 P.3d 976]*.)

[889]** II. *The Trial Court Was Free to Consider Whether Berg Had Stated Facts Sufficient to State a Cause of Action for Breach of Fiduciary Duty on Demurrer to the Third Amended Complaint*

As a preliminary matter, we dispense with Berg's claim that because of prior rulings on demurrers to its superseded pleadings, the trial court lacked jurisdiction to consider whether the third amended complaint alleged a viable cause of action for breach of fiduciary duty. Citing *Bennett v. Suncloud (1997) 56 Cal.App.4th 91 [65 Cal. Rptr. 2d 80]* (*Bennett*), Berg contends that the jurisdictional components of *Code of Civil Procedure section 1008*, the statute governing motions **[***28]** for reconsideration of prior rulings and renewed motions, [14] precluded the court from considering the viability of the breach-of-fiduciary-duty claim and that the only ground open for consideration on demurrer to the third amended complaint was that the claim was barred by the business judgment rule. Berg is mistaken.

CA(1)[] **(1)** *Bennett* did hold that ***HN4***[] where a prior demurrer was sustained as to some causes of action but overruled as to others, a defendant may not demur again on the same grounds to those portions of an amended pleading as to which the prior demurrer was *overruled*. (*Bennett, supra, 56 Cal.App.4th at pp. 96–97*.) But here, there was only one cause of action and the prior demurrers to that cause of action were *sustained*—a critical difference. And *Bennett* also affirmed the principle that when a plaintiff files an amended pleading in response to an order sustaining a prior demurrer to a cause of action with leave to amend,

[14] These components are generally that an application for reconsideration of a prior ruling or a renewed motion must be made on new or different facts, circumstances, or law. (*Code Civ. Proc., § 1008*.)

the amended cause of action is treated as a new pleading and a defendant **[***29]** is free to respond to it by demurrer on any ground. (*Ibid.*; *Clausing v. San Francisco Unified School Dist. (1990) 221 Cal.App.3d* ***[*1036]*** *1224, 1232 [271 Cal. Rptr. 72]*.) Accordingly, because defendants here demurred to the single cause of action of the new, third amended complaint as to which no prior demurrer had been overruled, the restrictive provisions of *Code of Civil Procedure section 1008* are inapplicable. [15]

It also bears noting that in spite of *Bennett*, **[***30]** we have previously concluded that a party is within its rights to successively demur to a cause of action in an amended pleading notwithstanding a prior unsuccessful demurrer to that same cause of action. (*Pavicich v. Santucci (2000) 85 Cal.App.4th 382, 389 [102 Cal. Rptr. 2d 125]*.) Citing earlier case law, we so concluded on the rationale that the "'interests of all parties are advanced by avoiding a trial and reversal for a defect in pleadings. The objecting party is acting properly in raising the point at his first opportunity, by general demurrer. If the demurrer is **[**890]** erroneously overruled, he is acting properly in raising the point again, at his next opportunity. If the trial judge made the former ruling himself [or herself], he [or she] is not bound by it. [Citation.] And, if the demurrer was overruled by a different judge, the trial judge is equally free to reexamine the sufficiency of the pleading. [Citations.]' [Citation.]" (*Pacific States Enterprises, Inc. v. City of Coachella (1993) 13 Cal.App.4th 1414, 1420, fn. 3 [17 Cal. Rptr. 2d 68]*.) [16]

Moreover, the role of this court entails review of the trial court's ruling, not its rationale. Thus, even if the trial court here were constrained by its prior rulings in its consideration of the grounds raised on demurrers to the third amended complaint, on review of the judgment, we are not so constrained and are free to render an opinion based on the correct rule of law. (*Bennett, supra, 56 Cal.App.4th at p. 97*.)

For all these reasons, we reject Berg's contention that the trial court erred by disposing of the third amended complaint based on Berg's failure to state a viable claim for breach of fiduciary duty and by not limiting its consideration of the pleading challenge to the bar of the business judgment rule.

[*1037]

III. *The Demurrer to Berg's Third Amended Complaint Was Properly Sustained*

A. *The Question of a Duty Owed by Individual Directors to Creditors*

Berg contends that the individual members of Pluris's board of directors owed Berg, and all of Pluris's creditors, a paramount fiduciary duty. The alleged duty arose beginning at a point in time when Pluris entered into that ill-defined sphere **[***32]** known as the "zone of insolvency." Respondent directors appear to accept that they owed creditors a duty of due care upon Pluris's actual insolvency. We begin our analysis by focusing on the question whether the individual directors owed creditors a duty and if so, when the duty arose and its scope.

CA(2)[] **(2)** It is without dispute that ***HN5***[] in California, corporate directors owe a fiduciary duty to the corporation and its shareholders and now as set out by statute, must serve "in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders." (*Corp. Code, § 309, subd. (a)*.) [17] This duty—generally to act with honesty,

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[15] We further observe that none of the court's prior rulings actually turned on a determination that Berg had stated a viable claim for breach of fiduciary duty. Its order on demurrer to the first amended complaint narrowly determined that Berg could not proceed with its claim directly but must do so derivatively. Its order sustaining the demurrers to the second amended complaint determined that a viable claim for breach of fiduciary duty had not been stated because on the face of the pleading, the business judgment rule barred the claim. In other words, the court did not separate the viability of the breach-of-fiduciary-duty claim from the presumption of the business judgment rule, concluding that a viable claim must plead facts to rebut the presumption.

[16] We have not had occasion to reassess this conclusion in light of *Le Francois v. Goel (2005) 35 Cal.4th 1094, 1096–1097 [29 Cal. Rptr. 3d 249, 112 P.3d 636]*, which in essence clarified that parties requesting reconsideration **[***31]** of a ruling or filing a renewed motion must comply with *Code of Civil Procedure section 1008*.

[17] *Corporations Code section 309, subdivision (a)* **[***33]** provides that "[a] director shall perform the duties of a director … in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances." A director "who performs the duties of a director in accordance with" this subdivision, as well as other subdivisions that permit reliance on information provided by

loyalty, and good faith—derived from the common law. (Lehman v. Superior Court (2006) 145 Cal.App.4th 109, 120–121 [51 Cal. Rptr. 3d 411] [director's fiduciary duty **[**891]** is not liability created by statute]; Jones v. H. F. Ahmanson & Co., supra, 1 Cal.3d at pp. 106–110 [discussing common law development of directors' fiduciary duty]; cf. Pittelman v. Pearce (1992) 6 Cal.App.4th 1436, 1446–1447 [8 Cal. Rptr. 2d 359] [corporate bondholders, unlike shareholders, not owed fiduciary duty; obligations owing are defined by contractual terms of bond].)

There is no analogous statutory authority in California establishing or recognizing that upon a corporation's insolvency, or more vaguely when it enters into a "zone of insolvency," directors instead or also owe a duty to the corporation's creditors. And it is easy to see that especially **[***34]** when a corporation is in financial distress, the interests of the shareholders and the corporation itself may inherently collide with those of the creditors, making any **[*1038]** respective duties owed by directors to each constituency potentially in conflict and making the scope of each respective duty elusive and difficult to ascertain.

The modern common law notion that the individual directors of a financially distressed corporation operating in the zone of insolvency or even upon insolvency owe a duty of care to its creditors finds its genesis in Credit Lyonnais Bank Nederland N.V. v. Pathe Communications Corp. (Del. Ch., Dec. 30, 1991, No. 12150) 1991 Del. Ch. Lexis 215 (*Credit Lyonnais*), which arose out of the leveraged buyout of MGM-Pathe Communications Co. and which laid the ground for the insolvency exception to the general rule that directors owe exclusive duties to the corporation and its shareholders, but not to creditors. While the Delaware chancellor in *Credit Lyonnais* did not find a breach of any duty in that case, he did posit in the text and in a well-known footnote that "[a]t least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes **[***35]** its duty to the corporate enterprise," i.e., the "community of interests" of those involved with the corporation, including its creditors. (Credit Lyonnais, supra, 1991 Del. Ch. Lexis 215 at p. *108 & fn. 55.) The recognition of such a duty was seen to minimize the risk to creditors of directors' "opportunistic behavior" like the disposition of corporate property at "fire-sale prices" or unreasonable risk taking with corporate assets for the sole benefit of shareholders. (Id. at pp. *108, fn. 55, *109.)

Subsequent federal and out-of-state decisions discussing *Credit Lyonnais* and grappling with the question and scope of a duty owed to creditors upon insolvency have underscored that when managing a corporation that is insolvent, directors must consider the best interests of the whole "corporate enterprise, encompassing all its constituent groups, without preference to any. That duty, therefore, requires directors to take creditor interests into account, but not necessarily to give those interests priority. In particular, it is not a duty to liquidate and pay creditors when the corporation is near insolvency, provided that in the directors' informed, good faith judgment there is an alternative. Rather, **[***36]** the scope of that duty to the corporate enterprise is 'to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity.'" (In re Ben Franklin Retail Stores, Inc. (Bankr. N.D.Ill. 1998) 225 B.R. 646, 655 (*Ben Franklin*); see also, e.g., Geyer v. Ingersoll Publications Co. (Del.Ch. 1992) 621 A.2d 784, 789–791; In re Hechinger Inv. Co. of Delaware (Bankr. D.Del. 2002) 274 B.R. 71, 89; In re RSL Com Primecall, Inc. (Bankr. S.D.N.Y., Dec. 11, 2003, Nos. 01-11457, 01-11469) 2003 Bankr. Lexis 1635, pp. *24–*25; Production Resources v. NCT Group (Del.Ch. 2004) 863 A.2d 772, 787–803, overruled in part in NACEPF v. Gheewalla (Del. 2007) 930 A.2d 92, 103.)
[*1039]

[892]** As generally discussed by the court in Ben Franklin, the rationale for the general rule of no duty owed to creditors is that it is the shareholders who own a corporation, which is managed by the directors. In an economic sense, when a corporation is solvent, it is the shareholders who are the residual claimants of the corporation's assets and who are the residual risk bearers. As long as the corporation remains solvent, the business decisions made by management directly affect the shareholders' income; management accordingly owes fiduciary duties to those shareholders as well as to the **[***37]** corporation. The corporation's creditors, on the other hand, are free to protect their interests by contract. As long as the corporation is solvent, no matter how badly managed it might be, it is able to satisfy its contractual obligations to creditors who are therefore

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others under certain circumstances not relevant here, "shall have no liability based upon any alleged failure to discharge the person's obligations as a director." (Corp. Code, § 309, subd. (c).) Accordingly, this section sets forth the standard of care owed by directors and accords directors immunity if they comply with that standard by codification of the common law business judgment rule, which we discuss *post*.

unaffected by management's business decisions. But when insolvency arises, the value of creditors' contract claims may be affected by management's business decisions in a way it was not before insolvency. At the same time, as long as insolvency persists, shareholder value is essentially worthless and shareholders no longer occupy the position of residual claimants. Because insolvency shifts the residual risk of management decisions from shareholders to creditors, at least some of the duties formerly owed by directors only to shareholders are owed also to creditors upon that circumstance, or so the theory goes. (Ben Franklin, supra, 225 B.R. at pp. 652?656; see also In re Verestar, Inc. (Bankr. S.D.N.Y. 2006) 343 B.R. 444, 471–472.) [18] **[*1040]**

CA(3)[] **(3)** There are apparently no published cases in California that rely on or postdate *Credit Lyonnais* and determine, based on acceptance or rejection of its rationale, whether or not in this state, corporate insolvency triggers the existence of fiduciary duties of due care and loyalty owed by directors to creditors. But, as observed by federal cases, **HN6**[] there are older California cases that, consistent with Pepper v. Litton (1939) 308 U.S. 295, 306–307 [84 L. Ed. 281, 60 S. Ct. 238], [19] apply the "'trust fund doctrine'" where "'all of the **[**893]** assets of a corporation, immediately on its becoming insolvent, become a trust fund for the benefit of all **[***40]** of its creditors'" in order to satisfy their claims. [20] (CarrAmerica, supra, 2006 U.S.Dist. Lexis 75399 at p. *16, citing Saracco Tank & Welding Co. v. Platz (1944) 65 Cal.App.2d 306, 313–318 [150 P.2d 918] [trust fund doctrine applied for statutory liability for dereliction imposed on directors for wrongful distribution of all assets of insolvent foreign corporation for payment to preferred creditors]; Commons v. Schine (1973) 35 Cal.App.3d 141, 145 [110 Cal. Rptr. 606] [trust fund doctrine applied to a controlling partner's preference in paying insolvent partnership's debt to his own creditor corporation]; *Title Ins. etc. Co. v. California Dev. Co. (1915) 171 Cal. 173, 206–207 [152 P. 542]* [trust fund doctrine applied to a company controlling an insolvent development corporation's preferential payment of the corporation's debts]; Bonney v. Tilley (1895) 109 Cal. 346, 351–352 [42 P. 439] [trust fund doctrine applied to directors of an insolvent corporation, who were also creditors of the corporation and who secured a preference to their claims over other creditors' claims];

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[18] The establishment of a general duty owed by corporate directors to creditors has generated controversy and has not been without a steady stream of broad criticism from commentators. Their writings on **[***38]** the subject focus on matters such as the difficulty of perceiving insolvency, or worse, the zone of insolvency, which is when such duties arise, and the practical difficulties and inefficiencies inherent in directors managing conflicting duties owed to disparate interests, thereby diluting the continuing and historic duty owed by directors to shareholders. Some commentators have even called for the abolition of the duty to creditors. (See, e.g., Lin, *Shift of Fiduciary Duty upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors* (1993) 46 Vand. L.Rev. 1485; Stilson, *Reexamining the Fiduciary Paradigm at Corporate Insolvency and Dissolution: Defining Directors' Duties to Creditors* (1995) 20 Del. J. Corp. L. 1; Schwarz, *Rethinking a Corporation's Obligation to Creditors* (1996) 17 Cardozo L.Rev. 647; Lipson, *Directors' Duties to Creditors: Power Imbalance and the Financially Distressed Corporation* (2003) 50 UCLA L.Rev. 1189; Sahyan, *The Myth of the Zone of Insolvency: Production Resources Group v. NCT Group* (Fall 2006) 3 Hastings Bus. L.J. 181; Bainbridge, *Much Ado About Little? Directors' Fiduciary Duties in the Vicinity of Insolvency* (2006–2007) 1 J. Bus. & Tech. L. 335; **[***39]** Hu & Westbrook, *Abolition of the Corporate Duty to Creditors* (2007) 107 Colum. L.Rev. 1321; Tung, *The New Death of Contract: Creeping Corporate Fiduciary Duties for Creditors* (2008) 57 Emory L.J. 809; McLaughlin, *The Uncertain Timing of Directors' Shifting Fiduciary Duties in the Zone of Insolvency: Using Altman's Z-Score to Synchronize the Watches of Courts, Directors, Creditors, and Shareholders* (Winter 2008) 31 Hamline L.Rev. 145; See also NACEPF v. Gheewalla, supra, 930 A.2d at p. 99, fn. 28 [listing many articles on the topic of duties owed to creditors on corporate insolvency].)

[19] *Pepper v. Litton* is a seminal United States Supreme Court case that established, among other things, that controlling shareholders, like directors, owe fiduciary duties that are "designed for the protection of the entire community of interests in the corporation—creditors as well as stockholders." (Pepper v. Litton, supra, 308 U.S. at p. 307, fn. omitted.) Transactions by such fiduciaries with the corporation therefore are rigorously scrutinized and must meet standards of good faith and inherent fairness from the viewpoint of the corporation and its interested constituencies, which include creditors. Such transactions must under all the relevant circumstances "carr[y] the earmarks of an arm's length bargain." (Id. at pp. 306–307, fn. omitted.) Transactions that fail to meet this standard may be set aside in a bankruptcy court under its equity powers. (*Ibid*.) The factual context of the case involved fraud and misconduct by the dominant shareholder amounting to self-dealing, none of which **[***42]** is even alleged here.

[20] For an excellent discussion of the trust fund doctrine under Delaware law, see In re JTS Corp. (Bankr. N.D.Cal. 2003) 305 B.R. 529, 535–536.

In re Wright Motor Co. (9th Cir. 1924) 299 F. 106, 109–110 [trust fund doctrine applied based on California law to a director's fraudulent transfer of corporate assets to himself]; **[***41]** see also *In re Jacks (Bankr. 9th Cir. 2001) 266 B.R. 728, 736* [trust fund doctrine applied under California law to a director's use of an insolvent corporation's assets to guarantee a personal debt].)

As observed in *CarrAmerica* and by the trial court here, recovery for breaching the fiduciary duties imposed under the trust fund doctrine in California "generally pertains to cases where the directors or officers of an insolvent corporation have diverted assets of the corporation 'for the benefit **[*1041]** of insiders or preferred creditors.' [Citations.]" (*CarrAmerica, supra, 2006 U.S.Dist. Lexis 75399 at pp. *16–*17*.) While no California cases "expressly limit the fiduciary duty under the trust fund doctrine to the prohibition of self-dealing or the preferential treatment of creditors, the scope of the trust fund doctrine in California is reasonably limited to cases where directors or officers have diverted, dissipated, or unduly risked the insolvent corporation's assets." (*Id. at p. *17*.) In other words, the doctrine is not applied to create a duty owed by directors to creditors solely due to a state of corporate insolvency. Application of the doctrine requires, in addition, that directors have engaged in conduct that diverted, dissipated, or **[***43]** unduly risked corporate assets that might otherwise have been used to satisfy creditors' claims.

CA(4)[] **(4)** Accordingly, based on this established doctrine, we conclude that under the current state of California law, ***HN7***[] there is no broad, paramount fiduciary duty of due care or loyalty that directors of an insolvent **[**894]** corporation owe the corporation's creditors solely because of a state of insolvency, whether derived from *Credit Lyonnais* or otherwise. And we decline to create any such duty, which would conflict with and dilute the statutory and common law duties that directors already owe to shareholders and the corporation. We also perceive practical problems with creating such a duty, among them a director's ability to objectively and concretely determine when a state of insolvency actually exists such that his or her duties to creditors have been triggered. We accordingly hold that the scope of any extracontractual duty owed by corporate directors to the insolvent corporation's creditors is limited in California, consistent with the trust fund doctrine, *to the avoidance of actions that divert, dissipate, or unduly risk corporate assets that might otherwise be used to pay creditors claims*. This **[***44]** would include acts that involve self-dealing or the preferential treatment of creditors. [21] Further, because all the California cases applying the trust fund doctrine appear to have dealt with actually insolvent entities, and because the existence of a zone or vicinity of insolvency is even less objectively determinable than actual insolvency, we hold that there is no fiduciary duty prescribed under California law that is owed to creditors by directors of a corporation solely by virtue of its operating in the "zone" or "vicinity" of insolvency. [22] **[*1042]**

CA(5)[] **(5)** Applying the scope of duty defined by the trust fund doctrine, and according truth to the well-pleaded facts of Berg's third amended complaint while ignoring its contentions, deductions, and conclusions of fact or law, we, like the trial court, conclude that the pleading fails to state facts constituting a cognizable claim for breach of fiduciary duty. Assuming a state of actual insolvency, which is not well pleaded here by facts, [23] and apart from the speculative and contingent

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[21] As Berg has not pleaded facts supporting fraud or concealment by the directors, we have no occasion to address that circumstance in our discussion. Nor does our conclusion displace the general obligation owed by all persons under *Civil Code section 1708*, which recognizes that "[e]very person is bound, without contract, to abstain from injuring the person or property of another, or infringing upon any of his or her rights."

[22] And we observe that the "vicinity of insolvency" breach-of-fiduciary-duty theory of liability was recently rejected, along with that of direct (as opposed to derivative) individual claims by creditors against directors **[***45]** of an insolvent corporation for breach of fiduciary duty, by the Delaware Supreme Court in *NACEPF v. Gheewalla, supra, 930 A.2d at pages 101–103*. We further observe that when an insolvent corporation files for relief in bankruptcy, duties owed to creditors as beneficiaries of the bankruptcy estate are then governed by the federal bankruptcy laws.

[23] There are multiple definitions of insolvency. *Corporations Code section 501* provides, for example, that a corporation is insolvent, if, as a result of a prohibited distribution, it would "likely … be unable to meet its liabilities … as they mature." But there is also insolvency in the balance sheet sense in which the value of liabilities exceeds the value of assets. (*In re Kallmeyer (Bankr. 9th Cir. 1999) 242 B.R. 492, 496–497* [affirming bankruptcy court's use of balance-sheet test for corporate insolvency in applying Oregon's trust fund doctrine in *11 U.S.C. § 523(a)(4)* context].) Berg did not plead any facts establishing Pluris's insolvency at any specific point in time under any test, only the conclusion that at all relevant times, the corporation was insolvent or in the zone of insolvency. In the Ninth Circuit Court of Appeals, a finding of insolvency by

nature of Berg's or Pluris's ability to actually carry forward and use Pluris's net operating losses against future income, [24] the thrust **[**895]** of Berg's claim, pleaded repeatedly, is as follows: The directors effected the assignment for the benefit of creditors, a recognized statutory alternative to liquidation through bankruptcy (*Credit Managers Assn. v. National Independent Business Alliance (1984) 162 Cal.App.3d 1166, [*1043] 1169–1170 [209 Cal.Rptr. 119])*, **[***46]** rather than investigating, exploring or pursuing a bankruptcy reorganization, through which Berg theoretically could have maximized the value of Pluris's accumulated net operating losses and the other creditors could have benefited from Berg's reorganization plan. [25]

These facts do not involve self-dealing or prohibited preferential treatment of creditors and further do not constitute the actual diversion, dissipation, or undue risking of Pluris's assets that were otherwise available to pay creditors' claims. At most, and contrary to Berg's contentions on appeal, these facts allege that another course of action, if explored and pursued, might have offered more value in the end **[**896]** or that beneficial, maximum, or more valuable use could thereby have been made of Pluris's net operating losses, assuming that the many contingencies required to successfully do so all would have transpired favorably. And to the extent the claim asserts that the breach was the failure to have contacted Berg in order to more fully explore the details of its reorganization plan before making the assignment, that failure alone cannot, as a matter of law, have constituted the diversion, dissipation, or undue risking of assets that **[***51]** could have otherwise been used to pay creditors' claims. Because of the inherently speculative and contingent nature of the plan, with or without its details, the obvious risks and costs associated with pursuing it would not have been eliminated by discussions with Carl Berg or anyone else.

Moreover, Berg did not plead facts that identified

the standard of a debtor not paying debts when they become due **[***47]** requires more than merely establishing the existence of a few unpaid debts. (*In re Dill (9th Cir. 1984) 731 F.2d 629, 632*.)

[24] Net operating losses, whose value depends on future income against which to apply them, have been considered property of a bankruptcy estate for purposes of title *11 United States Code sections 541(a)(1)* and *548(a)(1)*. (*In re Russell (8th Cir. 1991) 927 F.2d 413, 416–417*; *In re Prudential Lines Inc. (2d Cir. 1991) 928 F.2d 565, 571–573*.) In order to obtain benefit from net operating losses, an entity must comply with title *26 United States Code section 382* concerning ownership, control, and continuity of business enterprise and may not run afoul of title *26 United States Code section 269*, which prohibits the use of net operating losses when control of a company is acquired principally to evade taxes. Treasury regulations also limit and define an entity's ability to carry forward and use net operating losses. (See Trower, Federal Taxation of Bankruptcy and Workouts (1993) ¶ 7.08[6], pp. 7-91 to 7-96; II Weil et al., Reorganizing Failing Businesses (rev. ed. 2006) pp. 22-12 to 22-21.) We need not decide whether Pluris would **[***48]** have been able to comply with the complex federal statutes and Internal Revenue Service regulations concerning a taxpayer's ability to carry forward net operating losses in order to offset future gain, particularly in the context of a bankruptcy organization. Nor could we, given all the practical contingencies associated with that course of action, including but not limited to Pluris's ability to continue operations as a debtor in bankruptcy and its ability to generate future income against which to offset accumulated net operating losses. It suffices to say that directors contemplating a course of action such as a bankruptcy reorganization in an inherently speculative attempt to benefit from the corporation's net operating losses by carrying them forward to offset against potential gain would be engaging in a complex exercise of business judgment involving much risk that the endeavor would not ultimately be successful.

[25] We consider the new allegations of Berg's third amended complaint, that in February 2002, well before the assignment, Carl Berg informed the Pluris directors of some details of his reorganization plan, i.e., reduction of Berg's unsecured claim and its contribution of $ 150,000 to be apportioned **[***49]** among those other creditors, to be sham. Berg's superseded pleadings, of which we take judicial notice, clearly alleged that in February 2002, Carl Berg expressed *only* his desire to explore the use of Pluris's net operating losses if it was unable to obtain outside financing and that it was *only after* the assignment and during involuntary bankruptcy proceedings that Berg first offered any details of his plan. The later amendments to these allegations are inconsistent with these prior allegations. Under the sham-pleading doctrine, admissions in an original complaint that has been superseded by an amended pleading remain within the court's cognizance and the alteration of such statements by amendment designed to conceal fundamental vulnerabilities in a plaintiff's case will not be accepted. (*Deveny v. Entropin, Inc. (2006) 139 Cal.App.4th 408, 425–426, fn. 3 [42 Cal. Rptr. 3d 807]* [if a party files an amended pleading and attempts to avoid defects of original complaint by either omitting facts that rendered prior complaint defective or adding facts inconsistent with prior allegations, court may take judicial notice of prior pleadings and disregard inconsistent allegations or read into amended complaint the **[***50]** allegations of the superseded complaint] *Patane v. Kiddoo (1985) 167 Cal.App.3d 1207, 1213 [214 Cal. Rptr. 9]*.) We accordingly disregard the subject allegations of the third amended complaint and read into the operative pleading the previous allegations on the matter.

sources of funds or financing through which Pluris could have continued to operate even in bankruptcy, and thereby potentially generate profit within the allowed time period, which was necessary to successfully carrying forward and using the **[*1044]** net operating losses; it did not plead facts identifying options other than bankruptcy and reorganization according to its own plan through which Pluris could have carried forward its net operating losses; and it did not plead facts alleging just how, if they had not been squandered or had been better protected, the carry-forward of Pluris's accumulated net operating losses through bankruptcy could have been actually used *to pay or satisfy Berg's or its other existing creditors' claims*—the operative standard. (CarrAmerica, supra, 2006 U.S.Dist. Lexis 75399 at p. *20 [secret agreement by directors unrelated to protecting **[***52]** corporate assets in order to satisfy creditors' claims cannot form basis of breach of fiduciary duty]; Ben Franklin, supra, 225 B.R. at pp. 655–656 [existence of duty not to divert, dissipate, or unduly risk assets is only to protect creditors' contractual and priority rights and is only there to guard against risk that creditors' claims would be defeated by directors giving shareholders preferred rights to assets, which did not occur by prolongation of corporate life that did not result in creditors receiving less than full value for their claims].) Nor, as noted by the trial court, did Berg allege facts about the assignee, Sherwood Partners, Inc., that would have been discovered by reasonable inquiry and that would have foretold any breach by it of a fiduciary duty to creditors or other misconduct detrimental to them.

No matter how Berg now characterizes or packages the basic factual underpinnings of its claim, its allegations fail to state a cognizable cause of action for breach of fiduciary duty against the directors based on the trust fund doctrine, i.e., that the directors of the insolvent Pluris engaged in misconduct, self-dealing, or the prohibited preferential treatment of **[***53]** creditors, or that they diverted, dissipated, or unduly risked corporate assets that otherwise could have been used to pay or satisfy creditors' claims. The trial court was therefore correct in sustaining the demurrers to Berg's third amended complaint. Notwithstanding its many allegations about the directors' conduct while Pluris was in the zone of insolvency or even actually insolvent, the pleading still fails to state facts sufficient to constitute a cause of action for breach of fiduciary duty by the directors' having diverted, dissipated, or unduly risked corporate assets that might otherwise have been available to satisfy creditors' claims.

B. *The Bar of the Business Judgment Rule*

Even if we had determined that Berg had otherwise pleaded a cognizable claim for breach of fiduciary duty, we **[**897]** would still conclude that the directors are immune from liability on the claim based on the business judgment rule and, therefore, that the demurrers were correctly sustained. [26]

[*1045]

CA(6)[] **(6)** As noted, ***HN8***[] the business judgment rule has been codified in California at Corporations Code section 309. But the common law rule "has two components—one which immunizes directors from personal liability if they act in accordance with its requirements, and another which insulates from court intervention those management decisions which are made by directors in good faith in what the directors believe is the organization's best interest. [Citation.] Only the first component is embodied in Corporations Code section 309." (Lee v. Interinsurance Exchange (1996) 50 Cal.App.4th 694, 714 [57 Cal. Rptr. 2d 798] (*Lee*); see Lambden v. La Jolla Shores Clubdominium Homeowners Assn. (1999) 21 Cal.4th 249, 257 [87 Cal.Rptr.2d 237, 980 P.2d 940].) The broader rule is "'"a judicial policy of deference to the business judgment of corporate directors in the exercise of their broad discretion in making corporate decisions."' (Barnes [v. State Farm Mut. Auto Ins. Co. (1993) 16 Cal.App.4th 365,] 378 [20 Cal. Rptr. 2d 87]; Gaillard v. Natomas Co. [(1989) 208 Cal.App.3d 1250,] 1263 [256 Cal. Rptr. 702].) [It] is based on the premise that those to whom the management of **[***55]** a business organization has been entrusted, and not the courts, are best able to judge whether a particular act or transaction is helpful to the conduct of the organization's affairs or expedient for the attainment of its purposes. (Barnes, supra, 16 Cal.App.4th at p. 378; Eldridge v. Tymshare, Inc. (1986) 186 Cal.App.3d 767, 776 [230 Cal. Rptr. 815].) The rule establishes a presumption that directors' decisions are based on sound business judgment, and it prohibits courts from interfering in business decisions made by the directors in good faith and in the absence of a conflict of interest. (Katz v. Chevron Corp. (1994) 22 Cal.App.4th 1352, 1366 [27 Cal. Rptr. 2d 681]; Barnes,

[26] And based on these dispositive conclusions, we need not address respondents' other bases for challenging Berg's third amended complaint, including lack of standing, the failure to plead recoverable damages, and what **[***54]** appears to be a form of collateral estoppel based on the bankruptcy court's prior dismissal of the involuntary petition.

supra, 16 Cal.App.4th at pp. 379–380.)" (*Lee, supra, 50 Cal.App.4th at p. 711*.) "'A hallmark of the business judgment rule is that a court will not substitute its judgment for that of the board if the latter's decision can be "attributed to any rational business purpose." [Citation.]'" (*Katz, supra, 22 Cal.App.4th at p. 1366*.)

HN9[] ***CA(7)***[] **(7)** An exception to the presumption afforded by the business judgment rule accordingly exists in "circumstances which inherently raise an inference of conflict of interest" and the rule "does not shield actions taken without reasonable **[***56]** inquiry, with improper motives, or as a result of a conflict of interest." (*Everest Investors 8 v. McNeil Partners, supra, 114 Cal.App.4th at p. 430*; see *Lee, supra, 50 Cal.App.4th at p. 715*.) But a plaintiff must allege sufficient facts to establish these exceptions. To do so, more is needed than "conclusory allegations of improper motives and conflict of interest. Neither is it sufficient to generally allege the failure to conduct an active investigation, in the absence of (1) allegations of facts which would reasonably call for **[*1046]** such an investigation, or (2) allegations of facts which would have been discovered by a reasonable investigation and would have been material to the questioned exercise of business **[**898]** judgment." (*Lee, supra, at p. 715*.) In most cases, "the presumption created by the business judgment rule can be rebutted only by affirmative allegations of facts which, if proven, would establish fraud, bad faith, overreaching or an unreasonable failure to investigate material facts. [Citation.] Interference with the discretion of directors is not warranted in doubtful cases." (*Ibid*.)

CA(8)[] **(8)** And contrary to Berg's contention, ***HN10***[] the failure to sufficiently plead facts to rebut the business **[***57]** judgment rule or establish its exceptions may be raised on demurrer, as whether sufficient facts have been so pleaded is a question of law. (*Lee, supra, 50 Cal.App.4th at pp. 711–717* [judgment of dismissal following sustaining of demurrer affirmed on appeal for complaint's failure to have pleaded facts establishing exception to business judgment rule]; *Barnes v. State Farm Mut. Auto. Ins. Co., supra, 16 Cal.App.4th at pp. 378–379* [judgment of dismissal after sustaining of demurrer affirmed in part due to failure to allege facts rebutting business judgment rule]; *Findley v. Garrett (1952) 109 Cal.App.2d 166, 177–179 [240 P.2d 421]* [affirmance of sustained demurrer as pleading failed to allege fraud or bad faith as exception to business judgment rule].)

Berg acknowledges the elements of the business judgment rule but contends that it has sufficiently pleaded facts to rebut it. Specifically, it contends that it alleged facts that the directors failed to conduct a reasonable investigation into ways to protect Berg's interests when Pluris was in the zone of insolvency; and that given the information the board initially had about Berg's intention to use Pluris's net operating losses, it failed to investigate the details of Berg's bankruptcy **[***58]** reorganization plan or any other plan that would have facilitated such use, instead eliminating the possibility of deriving value from the losses by entering into the assignment. But what Berg has essentially alleged are not facts but the conclusion that the board simply did nothing by way of investigation of alternatives to the assignment. And the facts that are alleged—Pluris being in the zone of insolvency and the directors' knowledge of Berg's intention to explore ways to use Pluris's net operating losses—do not, without more, rebut the presumption.

First, as we have already concluded, in this state, corporate directors do not owe a fiduciary duty to creditors by reason of the corporation being in the zone or vicinity of insolvency. Under the trust fund doctrine, upon actual **[*1047]** insolvency, directors continue to owe fiduciary duties to shareholders and to the corporation but also owe creditors the duty to avoid diversion, dissipation, or undue risk to assets that might be used to satisfy creditors' claims. Under these circumstances, and even accepting as true Pluris's state of actual insolvency at the time of the assignment for the benefit of creditors and the directors' knowledge **[***59]** that Berg wished to use Pluris's net operating losses through a bankruptcy reorganization, the directors were not obliged to contact Berg or to pursue speculative, contingent and potentially risky and costly alternatives to the assignment simply in order to facilitate Berg's plan. The directors did not owe a paramount duty of loyalty to Berg over and above shareholders or other constituencies comprising the collective interests in the corporate enterprise that gave rise to an obligation to put Berg's interests above these other constituencies or to explore ways to facilitate Berg's desires above all else. This is particularly so when the asset—the net operating losses—the value of which Berg claims was not maximized was not a source of actual payment of creditors' claims.

[899]** Moreover, Berg did not plead facts demonstrating the availability of viable alternate sources of financing or facts that made the board's decision to enter into the assignment irrational, unsound, or unreasonable had the directors merely conducted an

adequate investigation into alternatives before doing so. Although Berg alleged the conclusion that the details of its reorganization plan would have benefited creditors, **[***60]** it did not allege facts establishing that its plan could have practically and reasonably been implemented or that its plan was less risky, less costly, or likely to succeed so as to enable Pluris or Berg and other creditors to benefit from its net operating losses. Nor did Berg allege facts identifying any other viable alternatives. Although Berg alleged in conclusory fashion a failure by the directors to investigate its plan, the pleading fails to state facts that reasonably called for further investigation or facts about its plan that if discovered by such investigation would have been material to the questioned exercise of business judgment. (*Lee, supra, 50 Cal.App.4th at p. 715*.) Berg suggests that it has pleaded a total abdication by the directors of their corporate responsibilities and an utter failure by the directors to diligently exercise their business judgment. (*Gaillard v. Natomas Co., supra, 208 Cal.App.3d at pp. 1263–1264* [business judgment rule does not immunize directors for abdication of duty by closing their eyes to what is going on in the conduct of the business].) But the mere fact of the assignment and the failure by the directors to pursue Berg's bankruptcy reorganization plan **[***61]** or some other unidentified alternative do not, as a matter of fact or law, establish abdication of duty; the failure to have exercised judgment with reasonable care, skill, and diligence; or even an unreasonable failure to have investigated so as to rebut or allege exceptions to the business judgment rule.
[*1048]

As noted, the business judgment rule has two components—immunization from liability that is codified at *Corporations Code section 309* and a judicial policy of deference to the exercise of good-faith business judgment in management decisions. We conclude that based on the allegations of Berg's third amended complaint that do not rebut the presumption afforded by the rule, both components apply here. Even if an otherwise cognizable claim for breach of fiduciary duty against the directors had been pleaded, the claim would still be barred by the business judgment rule. Accordingly, the demurrers would have properly been sustained on this ground as well.

IV. *The Court Did Not Abuse Its Discretion in Denying Leave to Amend*

As noted, a reviewing court must determine whether there is a reasonable possibility that a pleading as to which a demurrer has been sustained without leave to amend is **[***62]** capable of amendment to cure the defect. And it is the plaintiff who bears the burden of establishing that it is. (*Williams v. Housing Authority of Los Angeles, supra, 121 Cal.App.4th at p. 719*; *Campbell v. Regents of University of California, supra, 35 Cal.4th at p. 320*.)

Berg contends in its opening brief [27] that its third amended complaint can be still further amended to state new allegations **[**900]** establishing a viable cause of action for breach of fiduciary duty. The new allegations are: (1) The directors knowingly dissipated an asset—the net operating losses—by ceasing operations and making the assignment knowing that it would destroy the “creditors' ability to obtain” the losses; (2) Before the assignment, the directors paid preferred claims to employees with remaining cash; [28] (3) After the assignment, the directors became aware of the assignee's unscrupulous conduct in wasting Pluris's assets and did nothing about it. None of these allegations would cure the pleading defects we have identified so as to state a cognizable claim.

The first proposed allegation alleges nothing more or new in factual substance from that which is already alleged in the third amended complaint. Moreover, the directors' acts of knowingly ceasing operations and making the assignment, without more, do not constitute the intentional dissipation of an **[*1049]** asset that could otherwise be used to pay or satisfy creditors' claims. Accordingly, the allegation does not cure the existing failure to state a viable claim for breach of fiduciary duty under the trust fund doctrine.

As to the second allegation that the directors paid unidentified preferred employee wage or severance claims of unstated amounts just before the assignment, such claims are generally entitled to legal preference under state law governing assignments for the benefit of creditors (*Code Civ. Proc., § 1204*) and under federal bankruptcy law (*11 U.S.C. § 507(a)(4)*), as respondents point out. Thus, without other facts, such payments would not constitute the **[***64]** diversion, dissipation,

[27] To the extent Berg offered that it could allege other additional or different facts in its motion for reconsideration below, the same have been waived **[***63]** or forfeited on appeal for Berg's failure to raise them in its briefing.

[28] Berg does not identify these allegedly preferred creditors as employees in its opening brief but they were identified by Berg as such in the court below.

or undue risking of assets that would amount to a cognizable claim for breach of fiduciary duty.

CA(9)[] **(9)** Berg's third and final proposed new allegation is conclusory in that it states without specific facts that the directors became aware of the assignee's “unscrupulous” behavior in wasting Pluris's remaining assets after the assignment but did nothing about it, without specifically stating just what the directors could or should have done. Even more problematic is that the allegation does not state that the directors knew of facts *before* the assignment suggesting that the assignee would commit waste yet proceeded with the assignment anyway to the detriment of creditors. After the assignment, the assignee assumed the duty to marshal and protect Pluris's assets and the directors were thus no longer managing Pluris's affairs. (*Sherwood Partners, Inc. v. EOP-Marina Business Center, L.L.C., supra, 153 Cal.App.4th at p. 983*.) It follows that they, as individuals, ceased to owe any duty as directors to Pluris's creditors and were not legally responsible for acts of the assignee. Finally, as respondent Boyle argues, the factual allegation that Berg contacted the directors after **[***65]** the assignment to inform them of the assignee's unscrupulous conduct directly contradicts existing allegations of the third amended complaint to the effect that after the assignment, Berg was not in contact with the directors, and indeed was unable to contact them, and that Pluris then had no functioning board. HN11[] Under the sham pleading doctrine, we are free to disregard inconsistent allegations offered for amendment and we do so here.

In sum, Berg has not demonstrated that it can allege new facts that would cure the defects we have concluded exist in its third **[**901]** amended complaint. Based on the proposed new allegations, we remain unconvinced of the possibility that Berg's pleading can be amended to overcome these defects. Accordingly, we further conclude that the trial court did not abuse its discretion in sustaining the demurrers without leave to amend.

[*1050]

DISPOSITION

The judgment is affirmed.

Mihara, Acting P. J., and McAdams, J., concurred.

A petition for a rehearing was denied November 24, 2009, and appellant's petition for review by the Supreme Court was denied February 3, 2010, S178524. George, C. J., did not participate therein.

End of Document

Leslie v. Mihranian (In re Mihranian)

United States Court of Appeals for the Ninth Circuit

August 13, 2019, Argued and Submitted, Pasadena, California; September 9, 2019, Filed

No. 17-60090

Reporter

937 F.3d 1214 *; 2019 U.S. App. LEXIS 27108 **; Bankr. L. Rep. (CCH) P83,440; 2019 WL 4252115

IN RE MARDIROS HAIG MIHRANIAN, Debtor. SAM S. LESLIE, Chapter 7 Trustee, Appellant, v. HAIG LEO MIHRANIAN; MICHAEL MIHRANIAN; SUSAN CHOBANIAN; TAKOUHIE BARTAMIAN; MEDICAL CLINIC AND SURGICAL SPECIALTIES OF GLENDALE, INC., Appellees.

Prior History: [1]** Appeal from the Ninth Circuit Bankruptcy Appellate Panel. Agency No. 17-1048. Kurtz, Spraker, and Alston, Bankruptcy Judges, Presiding.

Leslie v. Mihranian (In re Mihranian), 2017 Bankr. LEXIS 4124 (9th Cir. Cal., Dec. 4, 2017)

Disposition: AFFIRMED.

Core Terms

consolidation, notice, Non-Debtors', bankruptcy court, parties, entities, adverse action

Case Summary

Overview

HOLDINGS: [1]-The bankruptcy court properly denied a Chapter 7 trustee's motion to substantively consolidate a debtor's estate with the estates of various non-debtors, including his ex-wife, sons, medical business, and office manager, because a party moving for substantive consolidation was required to give notice of the motion to creditors of a putative consolidated non-debtor, and the trustee failed to give such notice; [2]-The Bankruptcy Appeals Panel did not clearly err in concluding that the trustee failed to adequately research and serve the non-debtors' creditors where he relied on information for the ex-wife that was several years old, did not know or ask whether the office manager had any creditors, and made no attempts to discover the sons' creditors.

Outcome

Judgment affirmed.

LexisNexis® Headnotes

Bankruptcy Law > ... > Judicial Review > Standards of Review > De Novo Standard of Review

HN1[] **Standards of Review, De Novo Standard of Review**

On appeal, the circuit court reviews decisions of the Bankruptcy Appellate Panel (BAP) de novo, and thus reviews the bankruptcy court's decision under the same standards used by the BAP.

Bankruptcy Law > ... > Bankruptcy > Case Administration > Bankruptcy Court Powers

HN2[] **Case Administration, Bankruptcy Court Powers**

Substantive consolidation is not provided for in the Bankruptcy Code but is considered a general equitable power of bankruptcy courts.

Bankruptcy Law > ... > Commencement of Case > Joint Cases > Consolidation

HN3[] **Joint Cases, Consolidation**

Many courts, including the U.S. Court of Appeals for the Ninth Circuit, permit the substantive consolidation of both debtor and non-debtor entities. The sole aim of substantive consolidation is fairness to all creditors. The Ninth Circuit has adopted the Second Circuit's two-pronged test for substantive consolidation, Under this test, substantive consolidation is appropriate if either: (1) creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit; or (2) the affairs of the debtor are so entangled that consolidation will benefit all creditors.

Bankruptcy Law > ... > Commencement of Case > Joint Cases > Consolidation

HN4[] **Joint Cases, Consolidation**

The first prong of the In re Bonham test essentially requires notice to the putative consolidated parties' creditors, not just the putative consolidated parties. Under that prong, substantive consolidation is warranted where creditors dealt with the debtor and non-debtors as a single economic unit. The burden-shifting test for this prong places the burden on an objecting creditor to overcome a presumption that it did not rely on the separate credit of the putative consolidated entities. A creditor must be given notice of the motion for substantive consolidation and an opportunity to be heard in order to meet its burden of overcoming the presumption.

Bankruptcy Law > ... > Commencement of Case > Joint Cases > Consolidation

HN5[] **Joint Cases, Consolidation**

A party moving for substantive consolidation in a bankruptcy action must provide notice of the motion to the creditors of a putative consolidated non-debtor.

Summary:

SUMMARY[**]

Bankruptcy

The panel affirmed a decision of the Bankruptcy Appellate Panel affirming the bankruptcy court's denial of a Chapter 7 trustee's motion to substantively consolidate a debtor's estate with the estates of various non-debtors.

The panel held that a party moving for substantive consolidation must give notice of the motion to creditors of a putative consolidated non-debtor. Because no such notice was given, the panel affirmed.

Counsel: Robert M. Aronson (argued), Law Office of Robert M. Aronson APC, Los Angeles, California, for Appellant.

David B. Golubchik (argued) and John-Patrick M. Fritz, Levene Neale Bender Yoo & Brill LLP, Los Angeles, California, for Appellees.

Judges: Before: Mary M. Schroeder and Susan P. Graber, Circuit Judges, and Michael H. Watson,[*] District Judge. Opinion by Judge Watson.

[**] This summary constitutes no part of the opinion of the court. It has been prepared by court staff for the convenience of the reader.

[*] The Honorable Michael H. Watson, United States District Judge for the Southern District of Ohio, sitting by designation.

Opinion by: Michael H. Watson

Opinion

[*1215] WATSON, District Judge:

Sam S. Leslie, the Chapter 7 Trustee, appeals the decision of the Bankruptcy Appellate Panel for the Ninth Circuit ("BAP") affirming the bankruptcy court's denial of a motion to substantively consolidate ("SubCon Motion") **[**2]** Debtor Mardiros Mihranian's estate with the estates of various non-debtors. We affirm.

Beyond the Debtor, the pertinent parties in this case, whom we collectively refer to as the "Non-Debtors," include Debtor's ex-wife, Susan Chobanian; Debtor's and Susan's two sons, Michael and Haig Mihranian; Debtor's medical business, Medical Clinic and Surgical Specialties of Glendale, Inc. ("MCSSG"); and MCSSG's long-time office manager, Takouhie Bartamian. Two years after Debtor initiated his bankruptcy case, Trustee filed separate adversary actions to recover fraudulent transfers allegedly made to Susan, Haig, Michael, and Bartamian. Adv. No. 2:15-ap-01667-BR (Susan); Adv. No. 2:15-ap-01668-BR (Haig); Adv. No. 2:15-ap-01666-BR (Michael); Adv. No. 2:15-ap-01665-BR (Bartamian). While the adversary actions were pending,

Trustee filed the SubCon Motion in the bankruptcy action, seeking to substantively consolidate Debtor's estates with the estates of Susan, Haig, Michael, Bartamian, and MCSSG. Essentially, Trustee sought the same relief—recovery of Debtor's assets that allegedly were kept from judgment creditors through fraudulent transfers—in both the adversary actions and through the SubCon Motion. **[**3]** After permitting Trustee to amend the complaints in the adversary actions three times, the bankruptcy court granted the adversary defendants' motions to dismiss for failure to establish that Debtor was the initial transferor of the alleged fraudulent transfers, and those dismissals were upheld on appeal.

[*1216] Later, the bankruptcy court denied the SubCon Motion, providing its reasoning on the record at the hearing. During the hearing, the bankruptcy court asked Trustee's counsel several times whether he had given notice of the SubCon Motion to Non-Debtors' creditors. Additionally, the bankruptcy court concluded that the information Trustee needed to disentangle Debtor's assets from MCSSG's or Susan's assets was likely available through proper discovery, which Debtor had not sought to obtain until after the SubCon Motion was filed. Accordingly, the bankruptcy court concluded that Trustee had not proved that Debtor's assets were entangled with Non-Debtors' assets to such an extent as would justify substantive consolidation.

Trustee appealed the denial to the BAP, which affirmed because Trustee failed to serve the SubCon Motion on Non-Debtors' creditors. *Leslie v. Mihranian (In re Mihranian), No. CC-17-1048-KuSA, 2017 Bankr. LEXIS 4124, 2017 WL 6003345, at *1 (B.A.P. 9th Cir. Dec. 4, 2017)* **[**4]** . Trustee appeals to us, arguing that the law does not require a moving party to give notice of a SubCon Motion to a putative consolidated non-debtor's creditors and that, even if such notice is required, he provided the requisite notice.[1]

HN1[] "On appeal this court reviews decisions of the BAP *de novo*, and thus reviews the bankruptcy court's decision under the same standards used by the BAP." *Gaughan v. Edward Dittlof Revocable Tr. (In re Costas), 555 F.3d 790, 792 (9th Cir. 2009)* (internal quotation marks and citation omitted). Thus, we review *de novo* the BAP's legal conclusion that Non-Debtors' creditors should have received notice of the SubCon Motion and an opportunity to be heard.

HN2[] Substantive consolidation is not provided for in the Bankruptcy Code but is considered a general equitable power of bankruptcy courts. *Alexander v. Compton (In re Bonham), 229 F.3d 750, 763 (9th Cir. 2000)*. We explained the concept and history of substantive consolidation in *In re Bonham*:

> Orders of substantive consolidation combine the assets and liabilities of separate and distinct—but related—legal entities into a single pool and treat them as though they belong to a single entity. Substantive consolidation enables a bankruptcy court to disregard separate corporate entities . . . in order to reach assets for the satisfaction of debts of a related corporation. The consolidated assets create a single fund from which all claims against the consolidated debtors are satisfied . . . . Without the check of substantive consolidation, debtors

[1] Trustee also argues that the bankruptcy court clearly erred in failing to find entanglement sufficient to warrant substantive consolidation on the merits. Because we hold that notice of a SubCon Motion must be given to Non-Debtors' creditors and that such notice was not given in this case, we need not reach this argument.

> could insulate money through transfers among **[**5]** inter-company shell corporations with impunity.

Id. at 764 (internal quotation marks and citations omitted). ***HN3***[] Many courts, including this court, permit the substantive consolidation of both debtor and non-debtor entities. *See id. at 765*. The sole aim of substantive consolidation is "fairness to all creditors." *Id.* (internal quotation marks omitted). We have adopted the Second Circuit's two-pronged test for substantive consolidation,[2] but we have not yet determined **[*1217]** whether a party moving for substantive consolidation must give notice of the motion to creditors of a putative consolidated non-debtor. Several considerations support such a notice requirement.

First, caselaw in this circuit regarding consolidation of two or more debtors' estates supports extending a notice requirement to a putative consolidated non-debtor's creditors, who should be afforded just as much—if not more—notice as a putative consolidated debtor's creditors. *See Withers v. White (In re Foley), 4 F.2d 154, 157 (9th Cir. 1925)* (modifying an order consolidating the estates of two debtors after a majority concluded that "no such adjudication should [have been] made without first giving the creditors their day in court"). In other circuits, most courts that have addressed this issue require **[**6]** giving notice to a non-debtor's creditors prior to substantive consolidation. *See, e.g.*, *SE Prop. Holdings, LLC v. Stewart (In re Stewart), 571 B.R. 460, 473 (Bankr. W.D. Okla. 2017)*; *Mukamal v. Ark Capital Grp., LLC (In re Kodsi), No. 13-40134-LMI, 2015 Bankr. LEXIS 143, 2015 WL 222493, at *2 (Bankr. S.D. Fla. Jan. 14, 2015)*; *Fid. & Deposit Co. of Md. v. U.S. Bank N.A. (In re Kimball Hill, Inc.), No. 13 C 07146, 2014 U.S. Dist. LEXIS 155921, 2014 WL 5615650, at *4 (N.D. Ill. Nov. 4, 2014)*; *United States v. AAPC, Inc. (In re AAPC, Inc.), 277 B.R. 785, 789 (Bankr. D. Utah 2002)*; *Raslavich v. Ira S. Davis Storage Co. (In re Ira S. Davis, Inc.), No. 93-0530S, 1993 Bankr. LEXIS 1383, 1993 WL 384501, at *4 (E.D. Pa. Sept. 22, 1993)*; *Boston Valuation Grp., Inc. v. Hall (In re Tremont Place Realty Tr.), 159 B.R. 624, 625 n.1 (Bankr. D. Mass. 1993)*; *Morse Operations, Inc. v. Robins Le-Cocq, Inc. (In re Lease-A-Fleet, Inc.), 141 B.R. 869, 873 (Bankr. E.D. Pa. 1992)*; *In re Julien Co., 120 B.R. 930, 935 (W.D. Tenn. 1990)*; *In re Royal Crown Bottling Co. of Boaz, Inc., 26 B.R. 451, 452 (Bankr. N.D. Ala. 1983)*; *cf. Audette v. Kasemir (In re Concepts Am., Inc.), No. 14 B 34232, 2018 Bankr. LEXIS 1324, 2018 WL 2085615, at *3 (Bankr. N.D. Ill. May 3, 2018)*; *Yaquinto v. Ward (In re Ward), 558 B.R. 771, 799-800 (Bankr. N.D. Texas 2016)*; *In re Global Ocean Carriers Ltd., 251 B.R. 31, 34 (Bankr. D. Del. 2000)*. Although several cases outside this circuit have affirmed substantive consolidation without requiring separate notice to the putative consolidated entity's creditors, *see Farmers & Traders State Bank of Meredosia v. Magill (In re Meredosia Harbor & Fleeting Serv., Inc.), 545 F.2d 583, 589 (7th Cir. 1976)*; *Simon v. New Ctr. Hosp. (In re New Ctr. Hosp.), 187 B.R. 560, 566 (E.D. Mich. 1995)*; *In re Baker & Getty Fin. Servs., Inc., 78 B.R. 139, 143 (N.D. Ohio 1987)*, that approach is the "minority view."[3] *Kapila v. S&G Fin. Servs, LLC (In re S&G Fin. Servs. of S. Fla., Inc.), 451 B.R. 573, 585 n.14 (Bankr. S.D. Fla. 2011)*.

Second, if substantive consolidation is an equitable order the "sole aim" of which is "fairness to all creditors," *In re Bonham, 229 F.3d at 765* (internal quotation marks and citations omitted), then notice and an opportunity to be heard must be given to creditors of the putative consolidated parties—whose claims would be equitably distributed under the consolidation order—and not just to the consolidated parties themselves. That way, the bankruptcy court can hear from any objecting creditor before issuing its decision on consolidation and can ensure that the consolidation truly is fair to all affected creditors.

Third, and in the same vein, substantive consolidation "seriously . . . 'affects the **[*1218]** substantive rights of the creditors **[**7]** of the different estates.'" *Id. at 762* (quoting Adv. Ctte. Note to *Bankr. R. 1015*). It is logical to require that notice be given to the actual parties whose substantive rights will be "seriously affected" by the order so that they have an opportunity to be heard.

Fourth, ***HN4***[] the first prong of the *In re Bonham* test essentially requires notice to the putative consolidated

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[2] Under this test, substantive consolidation is appropriate if either: "(1) . . . creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit; or (2) . . . the affairs of the debtor are so entangled that consolidation will benefit all creditors." *In re Bonham, 229 F.3d at 766* (internal quotation marks omitted).

[3] Moreover, in those cases, the creditors were either functionally on notice by being present at the consolidation hearing (*Meredosia*), the creditors were unable to avoid consolidation (*New Ctr. Hosp.*), or due process was eventually provided (*Baker & Getty*).

parties' creditors, not just the putative consolidated parties. Under that prong, substantive consolidation is warranted where creditors dealt with the debtor and non-debtors as a single economic unit. The burden-shifting test for this prong places the burden on an objecting creditor to overcome a presumption that it did *not* rely on the separate credit of the putative consolidated entities. *Id. at 767* (citing *Drabkin v. Midland-Ross Corp. (In re Auto-Train Corp.), 810 F.2d 270, 276, 258 U.S. App. D.C. 151 (D.C. Cir. 1987))*. A creditor must be given notice of the motion for substantive consolidation and an opportunity to be heard in order to meet its burden of overcoming the presumption.

For all of these reasons, the BAP correctly concluded that ***HN5***[] a party moving for substantive consolidation must provide notice of the motion to the creditors of a putative consolidated non-debtor.

In this case, no such notice was given. We reject Trustee's argument that he provided notice **[**8]** to the same extent as was provided in *In re Bonham*. In that case, the defendants in the adversary actions, who were given notice of the motion for substantive consolidation, were the creditors of the putative consolidated parties; here, the notified parties were the putative consolidated parties themselves, not their creditors. Trustee's assertion that he provided the same notice as was given in *In re Bonham* therefore fails.

Moreover, a review of the record reveals that the BAP did not clearly err in concluding that Trustee failed to adequately research and serve Non-Debtors' creditors. Instead, Trustee relied on knowledge of MCSSG's and Susan's creditors that was several years old. He admitted that he did not know or ask whether Bartamian had any creditors and simply assumed from one of her bank statements that her only creditor was the owner of her mortgage. Michael's and Haig's creditors were not discussed at the hearing on the SubCon Motion, and there is no evidence in the record concerning any attempts Trustee may have made to discover Haig's or Michael's creditors. Trustee thus failed to show that he adequately researched the identity of, and provided notice to, Non-Debtors' creditors. **[**9]**

AFFIRMED.

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Commodity Futures Trading Com v. Weintraub

Supreme Court of the United States

March 19, 1985, Argued ; April 29, 1985, Decided

No. 84-261

Reporter

471 U.S. 343 *; 105 S. Ct. 1986 **; 85 L. Ed. 2d 372 ***; 1985 U.S. LEXIS 5 ****; 53 U.S.L.W. 4505; 12 Collier Bankr. Cas. 2d (MB) 651; 12 Bankr. Ct. Dec. 1247; Bankr. L. Rep. (CCH) P70,360; 1 Fed. R. Serv. 3d (Callaghan) 417

COMMODITY FUTURES TRADING COMMISSION v. WEINTRAUB ET AL.

Prior History: [**1]** CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

Disposition: *722 F.2d 338*, reversed.

Core Terms

attorney-client, waive, communications, shareholders, solvent, appointed, respondents', bankruptcy law, parties, bankruptcy trustee, fiduciary, functions

Case Summary

Procedural Posture

Petitioner Commodity Futures Trading Commission sought certiorari review of a decision by the United States Court of Appeals for the Seventh Circuit, which reversed a trial court decision and found that a bankruptcy trustee did not have the power to waive respondent commodity broker's attorney-client privilege.

Overview

Respondent commodity broker filed for Chapter 7 bankruptcy liquidation on the same day petitioner Commodity Exchange Commission filed a complaint against respondent for violating the Commodity Exchange Act, *7 U.S.C.S. § 1*. After the bankruptcy trustee was appointed, petitioner sought testimony from the former counsel for respondent regarding respondent's fraudulent activities. The counsel asserted the attorney-client privilege, and the trustee waived the privilege. A magistrate ordered the testimony, and respondent sought review. The trial court upheld the magistrate's order, and respondent appealed. The appellate court reversed and found that the trustee lacked the authority to waive the privilege. Petitioner sought review. The Court reversed the appellate court decision. The Court found that the power to exercise the attorney-client privilege in bankruptcy proceedings passed to the bankruptcy trustee and that the trustee had the power to waive the debtor corporation's privilege with respect to communications that took place prior to the filing of the bankruptcy petition.

Outcome

The Court reversed the appellate court's decision and agreed with the trial court that a bankruptcy trustee had the power to waive a respondent commodity broker's attorney-client privilege where that power was exercised in accordance with the trustee's fiduciary duty.

LexisNexis® Headnotes

Business & Corporate Law > ... > Directors & Officers > Management Duties & Liabilities > General Overview

Evidence > Privileges > Attorney-Client Privilege > General Overview

HN1[] **Directors & Officers, Management Duties & Liabilities**

The attorney-client privilege attaches to corporations as well as to individuals.

Business & Corporate Law > ... > Directors & Officers > Management Duties & Liabilities > General Overview

Evidence > Privileges > Attorney-Client Privilege > Waiver

Governments > Fiduciaries

Evidence > Privileges > Attorney-Client Privilege > General Overview

HN2[] **Directors & Officers, Management Duties & Liabilities**

The managers of a corporation must exercise the attorney-client privilege in a manner consistent with their fiduciary duty to act in the best interests of the corporation and not of themselves as individuals.

Business & Corporate Law > ... > Directors & Officers > Management Duties & Liabilities > General Overview

Evidence > Privileges > Attorney-Client Privilege > Scope

Evidence > Privileges > Attorney-Client Privilege > General Overview

Evidence > Privileges > Attorney-Client Privilege > Waiver

HN3[] **Directors & Officers, Management Duties & Liabilities**

Displaced corporate managers may not assert the attorney-client privilege over the wishes of current managers, even as to statements that the former might have made to counsel concerning matters within the scope of their corporate duties.

Bankruptcy Law > Procedural Matters > General Overview

Civil Procedure > Discovery & Disclosure > Discovery > Protective Orders

Bankruptcy Law > ... > Bankruptcy > Estate Property > Noncustodial Turnovers

HN4[] **Bankruptcy Law, Procedural Matters**

See *11 U.S.C.S. § 542(e)*.

Bankruptcy Law > Debtor Benefits & Duties > General Overview

Contracts Law > Types of Contracts > Lease Agreements > General Overview

Real Property Law > Purchase & Sale > Fraudulent Transfers

Bankruptcy Law > Case Administration > Examiners, Officers & Trustees > General Overview

Bankruptcy Law > ... > Examiners, Officers & Trustees > Duties & Functions > General Overview

Bankruptcy Law > ... > Examiners, Officers & Trustees > Duties & Functions > Capacities & Roles

Bankruptcy Law > ... > Examiners, Officers & Trustees > Duties & Functions > Liquidations

Bankruptcy Law > ... > Examiners, Officers & Trustees > Duties & Functions > Reorganizations

Bankruptcy Law > ... > Preferential Transfers > Elements > Preference Periods

Bankruptcy Law > ... > Bankruptcy > Estate Property > Contents of Estate

HN5[] Bankruptcy Law, Debtor Benefits & Duties

The powers and duties of a bankruptcy trustee are extensive. Upon the commencement of a case in bankruptcy, all corporate property passes to an estate represented by the trustee. 11 U.S.C.S. §§ 323, 541. The trustee is accountable for all property received, under 11 U.S.C.S. §§ 704(2) and 1106(a)(1) and has the duty to maximize the value of the estate under 11 U.S.C.S. § 704(1). The trustee is directed to investigate the debtor's financial affairs, pursuant to 11 U.S.C.S. §§ 704(4) and 1106(a)(3), and is empowered to sue officers, directors, and other insiders to recover, on behalf of the estate, fraudulent or preferential transfers of the debtor's property under 11 U.S.C.S. §§ 547(b)(4)(B) and 548. Subject to court approval, he may use, sell, or lease property of the estate. 11 U.S.C.S. § 363(b).

Bankruptcy Law > ... > Examiners, Officers & Trustees > Duties & Functions > Liquidations

Contracts Law > Types of Contracts > Lease Agreements > General Overview

Bankruptcy Law > ... > Examiners, Officers & Trustees > Duties & Functions > Reorganizations

HN6[] Duties & Functions, Liquidations

In reorganization, a trustee has the power to operate the debtor's business unless the court orders otherwise. Even in liquidation, 11 U.S.C.S. § 721 allows the court to authorize the trustee to operate the business for a limited period of time. In the course of operating the debtor's business, the trustee may enter into transactions, including the sale or lease of property of the estate without court approval. 11 U.S.C.S. § 363(c)(1).

Bankruptcy Law > ... > Bankruptcy > Estate Property > Custodial Turnovers

Bankruptcy Law > ... > Bankruptcy > Debtor Benefits & Duties > Debtor Duties

HN7[] Property Recovered by Trustee, Custodial Turnovers

The powers of a debtor's directors are severely limited. Their role is to turn over the corporation's property to the trustee and to provide certain information to the trustee and to the creditors. 11 U.S.C.S. §§ 521 and 343.

Bankruptcy Law > ... > Bankruptcy > Debtor Benefits & Duties > Debtor Duties

Evidence > Privileges > Attorney-Client Privilege > General Overview

HN8[] Debtor Benefits & Duties, Debtor Duties

In seeking to maximize the value of a debtor's estate, the trustee must investigate the conduct of prior management to uncover and assert causes of action against the debtor's officers and directors.

Bankruptcy Law > ... > Examiners, Officers & Trustees > Duties & Functions > Capacities & Roles

Business & Corporate Law > ... > Shareholders > Shareholder Duties & Liabilities > General Overview

Governments > Fiduciaries

Bankruptcy Law > ... > Examiners, Officers & Trustees > Duties & Functions > Reorganizations

HN9[] Duties & Functions, Capacities & Roles

The fiduciary duty of a bankruptcy trustee runs to a debtor's shareholders as well as to creditors.

Bankruptcy Law > ... > Liquidations > Estate Property Distribution > Distributions Among Unsecured Classes

Business & Corporate Law > ... > Dissolution & Receivership > Termination & Winding Up > General Overview

Evidence > Privileges > Attorney-Client Privilege > General Overview

Bankruptcy Law > ... > Examiners, Officers &

Trustees > Duties & Functions > Reorganizations

HN10[] **Estate Property Distribution, Distributions Among Unsecured Classes**

In cases in which it is clear that a corporation's bankruptcy estate is not large enough to cover any shareholder claims, the trustee's exercise of a debtor's attorney-client privilege will benefit only creditors, but there is nothing anomalous in this result; rather, it is in keeping with the hierarchy of interests created by the bankruptcy laws.

Bankruptcy Law > Reorganizations > Debtors in Possession > General Overview

Governments > Fiduciaries

Labor & Employment Law > Employment Relationships > Fiduciary Responsibilities

HN11[] **Reorganizations, Debtors in Possession**

The willingness of courts to leave debtors in possession is premised upon an assurance that the officers and managing employees can be depended upon to carry out the fiduciary responsibilities of a trustee.

Bankruptcy Law > Reorganizations > General Overview

Criminal Law & Procedure > ... > Fraud > Bankruptcy Fraud > Elements

HN12[] **Bankruptcy Law, Reorganizations**

By definition, corporations in bankruptcy are treated differently from solvent corporations. Insolvency is a most important and material fact, not only with individuals but with corporations, and with the latter as with the former the mere fact of its existence may change radically and materially its rights and obligations.

Lawyers' Edition Display

Decision

Trustee of corporation in bankruptcy held to have power to waive corporation's attorney-client privilege with respect to prebankruptcy communications.

Summary

A formal investigation was initiated by the Commodity Futures Trading Commission to determine whether a discount commodity brokerage corporation, registered with the Commission as a futures commission merchant, violated the Commodity Exchange Act (*7 USCS 1 et seq.*). On the same day that the Commission filed a complaint against the corporation, the sole director and officer of the corporation entered into a consent decree with the Commission, which provided for the appointment of a receiver and for the receiver to file a petition for liquidation. The receiver was later appointed as interim trustee and, finally, permanent trustee in bankruptcy. As part of its continuing investigation of the corporation, the Commission served a subpoena duces tecum upon the corporation's former counsel who, at deposition, refused to answer certain questions, asserting the corporation's attorney-client privilege. In response to the Commission's request, the trustee in bankruptcy waived any interest he had in the attorney-client privilege possessed by the corporation for any communications or information occurring or arising on or before the date of his appointment as receiver. The United States District Court for the Northern District of Illinois upheld a Magistrate's order requiring the former counsel to testify. The Court of Appeals for the Second Circuit reversed, holding that a bankruptcy trustee does not have the power to waive a corporate-debtor's attorney-client privilege with respect to communications that occurred before the filing of the bankruptcy petition (*722 F2d 338*).

On certiorari, the United States Supreme Court reversed. In an opinion by Marshall, J., expressing the unanimous view of the eight participating members of the court, it was held that the trustee of a corporation in bankruptcy has the power to waive the corporation's attorney-client privilege with respect to communications that took place before the filing of the petition in bankruptcy.

Powell, J., did not participate.

Headnotes

BANKRUPTCY §165 > EVIDENCE §706 > confidential communications -- waiver of attorney-client privilege by trustee-in-bankruptcy -- > Headnote:
LEdHN[1A][] [1A]LEdHN[1B][] [1B]LEdHN[1C][] [1C]LEdHN[1D][] [1D]

The trustee of a corporation in bankruptcy has the power to waive the corporation's attorney-client privilege with respect to communications that took place before the filing of the petition in bankruptcy.

CORPORATIONS §97 > EVIDENCE §706 > confidential communications -- waiver of attorney-client privilege on behalf of corporation -- > Headnote:
LEdHN[2][] [2]

The attorney-client privilege attaches to corporations as well as to individuals, and for solvent corporations, the power to waive the corporate attorney-client privilege rests with the corporation's management and is normally exercised by its officers and directors; when control of a corporation passes to new management, the authority to assert and waive the attorney-client privilege passes as well, and the new managers may waive the attorney-client privilege with respect to communications made by former officers and directors.

BANKRUPTCY §38 > practice and procedure -- compelling delivery of records -- > Headnote:
LEdHN[3][] [3]

To the extent that the trustee of a debtor corporation has the power to waive the corporation's attorney-client privilege, 542(e) of the Bankruptcy Code (11 USCS 542(e)), which provides that "subject to any applicable privilege," the court may order an attorney who holds recorded information relating to the debtor's property or financial affairs to disclose such information to the trustee, poses no bar on the trustee's ability to obtain materials within that attorney-client privilege; the "subject to any applicable privilege" language of the statute is merely an invitation for judicial determination of privilege questions.

BANKRUPTCY §168 > trustee in bankruptcy -- duties and liabilities -- > Headnote:
LEdHN[4][] [4]

The fiduciary duty of a bankruptcy trustee runs to shareholders as well as to creditors and if a debtor remains in possession--that is, if a trustee is not appointed--the debtor's directors bear essentially the same fiduciary obligation to creditors and shareholders as would the trustee for a debtor out of possession.

CORPORATIONS §197 > insolvency -- effect on rights and obligations -- > Headnote:
LEdHN[5][] [5]

Insolvency is a most important and material fact, not only with individuals but with corporations, and with the latter as with the former the mere fact of its existence may change radically and materially its rights and obligations.

Syllabus

Petitioner filed a complaint in Federal District Court alleging violations of the Commodity Exchange Act by Chicago Discount Commodity Brokers (CDCB), and respondent Frank McGhee, acting as sole director and officer of CDCB, entered into a consent decree that resulted in the appointment of a receiver who was ultimately appointed trustee in bankruptcy after he filed a voluntary petition in bankruptcy on behalf of CDCB. Respondent Weintraub, CDCB's former counsel, appeared for a deposition pursuant to a subpoena *duces tecum* served by petitioner as part of its investigation of CDCB, but refused to answer certain questions, asserting CDCB's attorney-client privilege. Petitioner then obtained a waiver of the privilege from the trustee as to any communications occurring on or before the date of his initial appointment as a receiver. The District Court upheld a Magistrate's order directing Weintraub to testify, but the Court of Appeals reversed, holding that a bankruptcy trustee does not have the power to waive a corporate debtor's attorney-client privilege with respect **[****2]** to communications that occurred before the filing of the bankruptcy petition.

Held: The trustee of a corporation in bankruptcy has the power to waive the corporation's attorney-client privilege with respect to prebankruptcy communications. Pp. 348-358.

(a) The attorney-client privilege attaches to corporations as well as to individuals, and with regard to solvent corporations the power to waive the privilege rests with the corporation's management and is normally exercised by its officers and directors. When control of the corporation passes to new management, the authority to assert and waive the privilege also passes, and the new managers may waive the privilege with respect to corporate communications made by former officers and directors. Pp. 348-349.

(b) The Bankruptcy Code does not explicitly address the question whether control of the privilege of a corporation in bankruptcy with respect to prebankruptcy communications passes to the bankruptcy trustee or, as respondents assert, remains with the debtor's directors. Respondents' contention that the issue is controlled by § 542(e) of the Code -- which provides that "[subject] to any applicable privilege," the court may **[****3]** order an attorney who holds recorded information relating to the debtor's property or financial affairs to disclose such information to the trustee -- is not supported by the statutory language or the legislative history. Instead, the history makes clear that Congress intended the courts to deal with privilege questions. Pp. 349-351.

(c) The Code gives the trustee wide-ranging management authority over the debtor, whereas the powers of the debtor's directors are severely limited. Thus the trustee plays the role most closely analogous to that of a solvent corporation's management, and the directors should not exercise the traditional management function of controlling the corporation's privilege unless a contrary arrangement would be inconsistent with policies of the bankruptcy laws. Pp. 352-353.

(d) No federal interests would be impaired by the trustee's control of the corporation's attorney-client privilege with respect to prebankruptcy communications. On the other hand, vesting such power in the directors would frustrate the Code's goal of empowering the trustee to uncover insider fraud and recover misappropriated corporate assets. Pp. 353-354.

(e) There is no merit to respondents' **[****4]** contention that the trustee should not obtain control over the privilege because, unlike the management of a solvent corporation, the trustee's primary loyalty goes not to shareholders but to creditors. When a trustee is appointed, the privilege must be exercised in accordance with the trustee's fiduciary duty to all interested parties. Even though in some cases the trustee's exercise of the privilege will benefit only creditors, such a result is in keeping with the hierarchy of interests created by the bankruptcy laws. Pp. 354-356.

(f) Nor is there any merit to other arguments of respondents, including the contentions that giving the trustee control over the privilege would have an undesirable chilling effect on attorney-client communications and would discriminate against insolvent corporations. The chilling effect is no greater here than in the case of a solvent corporation, and, by definition, corporations in bankruptcy are treated differently from solvent corporations. Pp. 356-358.

Counsel: Bruce N. Kuhlik argued the cause pro hac vice for petitioner. With him on the briefs were Solicitor General Lee, Deputy Solicitor General Bator, Kenneth M. Raisler, Whitney Adams, and Helen **[****5]** G. Blechman.

David A. Epstein argued the cause for respondents. With him on the brief for respondents McGhee et al. was Gary A. Weintraub, pro se. *

Judges: MARSHALL, J., delivered the opinion of Court, in which all other Members joined, except POWELL, J., who took no part in the consideration or decision of the case.

Opinion by: MARSHALL

Opinion

[*345] **[***376]** **[**1989]** JUSTICE **MARSHALL** delivered the opinion of the Court.

* John K. Notz, Jr., pro se, and David F. Heroy filed a brief for John K. Notz, Jr., Trustee, as amicus curiae urging reversal.

LEdHN[1A][] [1A]The question here is whether the trustee of a corporation in bankruptcy has the power to waive the debtor corporation's attorney-client privilege with respect to communications that took place before the filing of the petition in bankruptcy.

I

The case arises out of a formal investigation by petitioner Commodity Futures Trading Commission to determine whether Chicago Discount Commodity Brokers (CDCB), or persons associated with that firm, violated the Commodity Exchange Act, *7 U. S. C. § 1 et seq.* CDCB was a discount commodity brokerage house registered with the Commission, pursuant to *7 U. S. C. § 6d(1)*, as a futures commission merchant. On October 27, 1980, **[****6]** the Commission filed a complaint against CDCB in the United States District Court for the Northern District of Illinois alleging violations of the Act. That same day, respondent Frank McGhee, acting as sole director and officer of CDCB, entered into a consent decree with the Commission, which provided for the appointment of a receiver and for the receiver to file a petition for liquidation under Chapter 7 of the Bankruptcy Reform Act of 1978 (Bankruptcy Code). The District Court appointed John K. Notz, Jr., as receiver.

Notz then filed a voluntary petition in bankruptcy on behalf of CDCB. He sought relief under Subchapter IV of Chapter 7 of the Bankruptcy Code, which provides for the **[*346]** liquidation of bankrupt commodity brokers. *11 U. S. C. §§ 761-766*. The Bankruptcy Court appointed Notz as interim trustee and, later, as permanent trustee.

As part of its investigation of CDCB, the Commission served a subpoena *duces tecum* upon CDCB's former counsel, respondent Gary Weintraub. The Commission sought Weintraub's testimony about various CDCB matters, including suspected misappropriation of customer funds by CDCB's officers and employees, and other fraudulent activities. **[****7]** Weintraub appeared for his deposition and responded to numerous inquiries but refused to answer 23 questions, asserting CDCB's attorney-client privilege. The Commission **[***377]** then moved to compel answers to those questions. It argued that Weintraub's assertion of the attorney-client privilege was inappropriate because the privilege could not be used to "thwart legitimate access to information sought in an administrative investigation." App. 44.

[1990]** Even though the Commission argued in its motion that the matters on which Weintraub refused to testify were not protected by CDCB's attorney-client privilege, it also asked Notz to waive that privilege. In a letter to Notz, the Commission maintained that CDCB's former officers, directors, and employees no longer had the authority to assert the privilege. According to the Commission, that power was vested in Notz as the then-interim trustee. *Id*., at 47-48. In response to the Commission's request, Notz waived "any interest I have in the attorney/client privilege possessed by that debtor for any communications or information occurring or arising on or before October 27, 1980" -- the date of Notz' appointment as receiver. *Id* **[****8]** ., at 49.

On April 26, 1982, a United States Magistrate ordered Weintraub to testify. The Magistrate found that Weintraub had the power to assert CDCB's privilege. He added, however, that Notz was "successor in interest of all assets, rights and privileges of CDCB, including the attorney/client privilege at issue herein," and that Notz' waiver was therefore valid. App. to Pet. for Cert. 19a-20a. The District Court **[*347]** upheld the Magistrate's order on June 9. *Id*., at 18a. Thereafter, Frank McGhee and his brother, respondent Andrew McGhee, intervened and argued that Notz could not validly waive the privilege over their objection. Record, Doc. No. 49, p. 7. [1] **[****9]** The District Court rejected this argument and, on July 27, entered a new order requiring Weintraub to testify without asserting an attorney-client privilege on behalf of CDCB. App. to Pet. for Cert. 17a. [2]

The McGhees appealed from the District Court's order of July 27 and the Court of Appeals for the Seventh Circuit reversed. *722 F.2d 338 (1984)*. It held that a bankruptcy trustee does not have the power to waive a corporate debtor's attorney-client privilege with respect to communications that occurred before the filing of the bankruptcy petition. The court recognized that two other Circuits had addressed the question and had come to the opposite conclusion. See *In re O. P. M. Leasing Services, Inc., 670 F.2d 383 (CA2 1982)*; *Citibank, N. A.* v. *Andros, 666 F.2d 1192 (CA8 1981)*. [3] We granted

[1] The Court of Appeals found that Andrew McGhee resigned his position as officer and director of CDCB on October 21, 1980. *722 F.2d 338, 339 (1984)*. Frank McGhee, however, remained as an officer and director. See n. 5, *infra*.

[2] The June 9 order had not made clear that Weintraub was barred only from invoking the *corporation's* attorney-client privilege.

[3] The Court of Appeals distinguished *O. P. M. Leasing*, where

certiorari to resolve **[***378]** the conflict. *469 U.S. 929 (1984)*. We now reverse the Court of Appeals.

[**10]** **[*348]** II

LEdHN[2][] [2]It is by now well established, and undisputed by the parties to this case, that ***HN1***[] the attorney-client privilege attaches to corporations as well as to individuals. *Upjohn Co*. v. *United States, 449 U.S. 383 (1981)*.Both for corporations and individuals, the attorney-client privilege serves the function of promoting full and frank communications between attorneys and their clients. It thereby encourages observance of the law and aids in the administration of justice. See, *e. g., Upjohn Co*. v. *United States, supra, at 389*; *Trammel v. United States, 445 U.S. 40, 51 (1980)*; *Fisher v. **[**1991]** United States, 425 U.S. 391, 403 (1976)*.

The administration of the attorney-client privilege in the case of corporations, however, presents special problems. As an inanimate entity, a corporation must act through agents. A corporation cannot speak directly to its lawyers. Similarly, it cannot directly waive the privilege when disclosure is in its best interest. Each of these actions must necessarily be undertaken by individuals empowered to act on behalf of the corporation. In *Upjohn Co*., **[****11]** we considered whether the privilege covers only communications between counsel and top management, and decided that, under certain circumstances, communications between counsel and lower-level employees are also covered. Here, we face the related question of which corporate actors are empowered to waive the corporation's privilege.

The parties in this case agree that, for solvent corporations, the power to waive the corporate attorney-client privilege rests with the corporation's management and is normally exercised by its officers and directors. [4]

HN2[] The managers, of **[*349]** course, must exercise the privilege in a manner consistent with their fiduciary duty to act in the best interests of the corporation and not of themselves as individuals. See, *e. g., Dodge v. Ford Motor Co., 204 Mich. 459, 507, 170 N. W. 668, 684 (1919)*.

[**12]** The parties also agree that when control of a corporation passes to new management, the authority to assert and waive the corporation's attorney-client privilege passes as well. New managers installed as a result of a takeover, merger, loss of confidence by shareholders, or simply normal succession, may waive the attorney-client privilege with respect to communications made by former officers and directors. ***HN3***[] Displaced managers may not assert the privilege over the wishes of current managers, even as to statements **[***379]** that the former might have made to counsel concerning matters within the scope of their corporate duties. See Brief for Petitioner 11; Tr. of Oral Arg. 26. See generally *In re O. P. M. Leasing Services, Inc., supra, at 386*; *Citibank v. Andros, supra, at 1195*; *In re Grand Jury Investigation, 599 F.2d 1224, 1236 (CA3 1979)*; *Diversified Industries, Inc*. v. *Meredith, 572 F.2d 596, 611, n. 5 (CA8 1978)* (en banc). [5]

[**13]** The dispute in this case centers on the control of the attorney-client privilege of a corporation in bankruptcy. The Government maintains that the power to exercise that privilege with respect to prebankruptcy communications passes to the bankruptcy trustee. In contrast, respondents maintain that this power remains with the debtor's directors.

III

As might be expected given the conflict among the

waiver of the privilege was opposed by the corporation's sole voting stockholder, on the ground that the corporation in *O. P. M. Leasing* had no board of directors in existence during the tenure of the trustee. Here, instead, Frank McGhee remained an officer and director of CDCB during Notz' trusteeship. *722 F.2d, at 341*. The court acknowledged, however, a square conflict with *Citibank* v. *Andros*.

After the Court of Appeals' decision in this case, the Court of Appeals for the Ninth Circuit held that a bankruptcy examiner has the power to waive the corporation's attorney-client privilege over the objections of the debtor-in-possession. *In re Boileau, 736 F.2d 503 (1984)*. That holding also conflicts with the holding of the Seventh Circuit in this case.

[4] State corporation laws generally vest management authority in a corporation's board of directors. See, *e. g*., *Del. Code Ann., Tit. 8, § 141* (1983); *N. Y. Bus. Corp. Law § 701* (McKinney Supp. 1983-1984); Model Bus. Corp. Act § 35 (1979). The authority of officers derives legally from that of the board of directors. See generally Eisenberg, Legal Models of Management Structure in the Modern Corporation: Officers, Directors, and Accountants, 63 Calif. L. Rev. 375 (1975). The distinctions between the powers of officers and directors are not relevant to this case.

[5] It follows that Andrew McGhee, who is now neither an officer nor a director, see n. 1, *supra*, retains no control over the corporation's privilege. The remainder of this opinion therefore focuses on whether Frank McGhee has such power.

Courts of Appeals, the Bankruptcy Code does not explicitly address **[*350]** the question before us. Respondents assert that *11 U. S. C. § 542(e)* is dispositive, but we find reliance on that provision misplaced. *Section 542(e)* states:

HN4[] *"Subject to any applicable privilege*, after notice and a hearing, the court may order an attorney, accountant, or other person that holds recorded information, including books, documents, records, and papers, relating to the debtor's property or financial affairs, to disclose such recorded **[**1992]** information to the trustee" (emphasis added).

According to respondents, the "subject to any applicable privilege" language means that the attorney cannot be compelled to turn over to the trustee materials within the corporation's attorney-client privilege. In **[****14]** addition, they claim, this language would be superfluous if the trustee had the power to waive the corporation's privilege.

LEdHN[3][] [3]The statutory language does not support respondents' contentions. First, the statute says nothing about a trustee's authority to waive the corporation's attorney-client privilege. To the extent that a trustee has that power, the statute poses no bar on his ability to obtain materials within that privilege. Indeed, a privilege that has been properly waived is not an "applicable" privilege for the purposes of *§ 542(e)*.

Moreover, rejecting respondents' reading does not render the statute a nullity, as privileges of parties other than the corporation would still be "applicable" as against the trustee. For example, consistent with the statute, an attorney could invoke the personal attorney-client privilege of an individual manager.

The legislative history also makes clear that Congress did not intend to give the debtor's directors the right to assert the corporation's attorney-client privilege against the trustee. Indeed, statements made by Members of Congress regarding the effect of *§ 542(e)* "specifically deny any attempt to create an attorney-client privilege **[****15]** assertable on behalf of the debtor against the trustee." *In re O. P. M. Leasing **[*351]** Services, Inc., 13 B. R. 54, 70 **[***380]** (SDNY 1981)* (Weinfeld, J.), aff'd, *670 F.2d 383 (CA2 1982)*; see also 4 Collier on Bankruptcy para. 542.06 (15th ed. 1985). Rather, Congress intended that the courts deal with this problem:

"The extent to which the attorney client privilege is valid against the trustee is unclear under current law and is left to be determined by the courts on a case by case basis." 124 Cong. Rec. 32400 (1978) (remarks of Rep. Edwards); *id*., at 33999 (remarks of Sen. DeConcini).

The "subject to any applicable privilege" language is thus merely an invitation for judicial determination of privilege questions.

In addition, the legislative history establishes that *§ 542(e)* was intended to restrict, not expand, the ability of accountants and attorneys to withhold information from the trustee. Both the House and the Senate Reports state that *§ 542(e)* "is a new provision that deprives accountants and attorneys of the leverage that they [had], . . . under State law lien provisions, to receive payment in full ahead of other creditors **[****16]** when the information they hold is necessary to the administration of the estate." S. Rep. No. 95-989, p. 84 (1978); H. R. Rep. No. 95-595, pp. 369-370 (1977). It is therefore clear that *§ 542(e)* was not intended to limit the trustee's ability to obtain corporate information.

IV

In light of the lack of direct guidance from the Code, we turn to consider the roles played by the various actors of a corporation in bankruptcy to determine which is most analogous to the role played by the management of a solvent corporation. See *Butner v. United States, 440 U.S. 48, 55 (1979)*. Because the attorney-client privilege is controlled, outside of bankruptcy, by a corporation's management, the actor whose duties most closely resemble those of management **[*352]** should control the privilege in bankruptcy, unless such a result interferes with policies underlying the bankruptcy laws.

A

HN5[] The powers and duties of a bankruptcy trustee are extensive. Upon the commencement of a case in bankruptcy, all corporate property passes to an estate represented by the trustee. *11 U. S. C. §§ 323*, *541*. The trustee is "accountable for all property received," *§§ 704(2)*, *1106(a)(1)*, **[**1993]** and **[****17]** has the duty to maximize the value of the estate, see *§ 704(1)*; *In re Washington Group, Inc., 476 F.Supp. 246, 250 (MDNC 1979)*, aff'd *sub nom. Johnston v. Gilbert, 636 F.2d 1213 (CA4 1980)*, cert. denied, *452 U.S. 940 (1981)*. He is directed to investigate the debtor's financial affairs, *§§ 704(4)*, *1106(a)(3)*, and is empowered to sue officers, directors, and other insiders to recover, on behalf of the estate, fraudulent or preferential transfers of the debtor's property, *§§ 547(b)(4)(B)*, *548*. Subject to court approval, he may use, sell, or lease property of the estate. § 363(b).

Moreover, HN6[] in reorganization, the trustee has the power to "operate the debtor's business" unless the court orders otherwise. § 1108. Even in liquidation, the court "may authorize the trustee to operate the business" for a limited period of time. § 721. In the course of operating the **[***381]** debtor's business, the trustee "may enter into transactions, including the sale or lease of property of the estate" without court approval. § 363(c)(1).

As even this brief and incomplete list should indicate, the Bankruptcy Code gives the trustee wide-ranging **[****18]** management authority over the debtor. See 2 Collier on Bankruptcy para. 323.01 (15th ed. 1985). In contrast, HN7[] the powers of the debtor's directors are severely limited. Their role is to turn over the corporation's property to the trustee and to provide certain information to the trustee and to the creditors. §§ 521, 343. Congress contemplated that when a trustee is appointed, he assumes control of the business, and **[*353]** the debtor's directors are "completely ousted." See H. R. Rep. No. 95-595, pp. 220-221 (1977). [6]

LEdHN[1B][] [1B]In light of the Code's allocation of responsibilities, it is clear that the trustee plays the role most closely analogous to that of a solvent corporation's management. Given that the debtor's directors retain virtually no management powers, they should not exercise the traditional management **[****19]** function of controlling the corporation's attorney-client privilege, see supra, at 348, unless a contrary arrangement would be inconsistent with policies of the bankruptcy laws.

B

We find no federal interests that would be impaired by the trustee's control of the corporation's attorney-client privilege with respect to prebankruptcy communications. On the other hand, the rule suggested by respondents -- that the debtor's directors have this power -- would frustrate an important goal of the bankruptcy laws. HN8[] In seeking to maximize the value of the estate, the trustee must investigate the conduct of prior management to uncover and assert causes of action against the debtor's officers and directors. See generally 11 U. S. C. §§ 704(4), 547, 548. It would often be extremely difficult to conduct this inquiry if the former management were allowed to control the corporation's attorney-client privilege and therefore to control access to the corporation's legal files. To the extent that management had wrongfully diverted or appropriated corporate assets, it could use the privilege as a shield against the trustee's efforts to identify those assets. The Code's goal of uncovering insider **[****20]** fraud would be substantially defeated if the debtor's directors were to retain the one management power that might effectively thwart an investigation into their own **[*354]** conduct. See generally *In re Browy, 527 F.2d 799, 802 (CA7 1976) (per curiam)*.

Respondents contend that the trustee can adequately investigate fraud without controlling the corporation's attorney-client privilege. They point out that the privilege does not shield the disclosure of communications relating to the planning or commission of ongoing fraud, crimes, and ordinary **[**1994]** torts, see, *e. g.*, Clark v. United States, 289 U.S. 1, 15 (1933); Garner v. Wolfinbarger, 430 F.2d 1093, 1102-1103 (CA5 1970), cert. denied, *401 U.S. 974* ***[***382]*** *(1971)*. Brief for Respondents 11. The problem, however, is making the threshold showing of fraud necessary to defeat the privilege. See Clark v. United States, supra, at 15. Without control over the privilege, the trustee might not be able to discover hidden assets or looting schemes, and therefore might not be able to make the necessary showing.

LEdHN[1C][] [1C]In summary, we conclude **[****21]** that vesting in the trustee control of the corporation's attorney-client privilege most closely comports with the allocation of the waiver power to management outside of bankruptcy without in any way obstructing the careful design of the Bankruptcy Code.

V

Respondents do not seriously contest that the bankruptcy trustee exercises functions analogous to those exercised by management outside of bankruptcy, whereas the debtor's directors exercise virtually no management functions at all. Neither do respondents seriously dispute that vesting control over the attorney-client privilege in the trustee will facilitate the recovery of misappropriated corporate assets.

Respondents argue, however, that the trustee should not obtain control over the privilege because, unlike the management of a solvent corporation, the trustee's primary loyalty goes not to shareholders but to creditors,

[6] While this reference is to the role of a trustee in reorganization, nothing in the Code or its legislative history suggests that the debtor's directors enjoy substantially greater powers in liquidation.

who elect him and who often will be the only beneficiaries of his efforts. See 11 U. S. C. §§ 702 (creditors elect trustee), 726(a) (shareholders **[*355]** are last to recover in bankruptcy). Thus, they contend, as a practical matter bankruptcy trustees represent only the creditors. Brief for Respondents **[****22]** 22.

LEdHN[4][] [4]We are unpersuaded by this argument. First, **HN9**[] the fiduciary duty of the trustee runs to shareholders as well as to creditors. See, *e. g., In re Washington Group, Inc., 476 F.Supp., at 250*;In re Ducker, 134 F. 43, 47 (CA6 1905).[7] Second, respondents do not explain why, out of all management powers, control over the attorney-client privilege should remain with those elected by the corporation's shareholders. Perhaps most importantly, respondents' position ignores the fact that bankruptcy causes fundamental changes in the nature of corporate relationships. One of the painful facts of bankruptcy is that the interests of shareholders become subordinated to the interests of creditors. **HN10**[] In cases in which it is clear that the estate is not large enough to cover any shareholder claims, the trustee's exercise of the corporation's attorney-client privilege will benefit only creditors, but there is nothing anomalous in this result; rather, it is in keeping with the hierarchy of interests created by the bankruptcy laws. See generally 11 U. S. C. § 726(a).

[**23]** Respondents also ignore that if a debtor remains in possession -- that is, if a trustee is not appointed -- the debtor's directors bear essentially **[***383]** the same fiduciary obligation to creditors and shareholders as would the trustee for a debtor out of possession. Wolf v. Weinstein, 372 U.S. 633, 649-652 (1963). Indeed, **HN11**[] the willingness of courts to leave debtors in possession "is premised upon an assurance that the officers and managing employees can be depended upon to carry out the fiduciary responsibilities of a trustee." Id., at 651. Surely, then, the management of a debtor-in-possession **[*356]** would have to exercise control of the corporation's attorney-client privilege consistently with this obligation to treat all parties, not merely the shareholders, fairly. By the same token, when a trustee is appointed, the privilege must be **[**1995]** exercised in accordance with the trustee's fiduciary duty to all interested parties.

To accept respondents' position would lead to one of two outcomes: (1) a rule under which the management of a debtor-in-possession exercises control of the attorney-client privilege for the benefit only of shareholders **[****24]** but exercises all of its other functions for the benefit of both shareholders and creditors, or (2) a rule under which the attorney-client privilege is exercised for the benefit of both creditors and shareholders when the debtor remains in possession, but is exercised for the benefit only of shareholders when a trustee is appointed. We find nothing in the bankruptcy laws that would suggest, much less compel, either of these implausible results.

VI

Respondents' other arguments are similarly unpersuasive. First, respondents maintain that the result we reach today would also apply to *individuals* in bankruptcy, a result that respondents find "unpalatable." Brief for Respondents 27. But our holding today has no bearing on the problem of individual bankruptcy, which we have no reason to address in this case. As we have stated, a corporation, as an inanimate entity, must act through agents. See *supra, at 348*. When the corporation is solvent, the agent that controls the corporate attorney-client privilege is the corporation's management. Under our holding today, this power passes to the trustee because the trustee's functions are more closely analogous to those of management **[****25]** outside of bankruptcy than are the functions of the debtor's directors. An individual, in contrast, can act for himself; there is no "management" that controls a solvent individual's attorney-client privilege. If control over that privilege passes to a trustee, it must be **[*357]** under some theory different from the one that we embrace in this case.

Second, respondents argue that giving the trustee control over the attorney-client privilege will have an undesirable chilling effect on attorney-client communications. According to respondents, corporate managers will be wary of speaking freely with corporate counsel if their communications might subsequently be disclosed due to bankruptcy. See Brief for Respondents 37-42; see also 722 F.2d, at 343. But the chilling effect is no greater here than in the case of a solvent corporation, where individual officers and directors always run the risk that successor management might waive the corporation's attorney-client privilege with

[7] The propriety of the trustee's waiver of the attorney-client privilege in a particular case can, of course, be challenged in the bankruptcy court on the ground that it violates the trustee's fiduciary duties. Respondents, however, did not challenge the waiver on those grounds; rather, they asserted that the trustee never has the power to waive the privilege.

respect to prior management's **[***384]** communications with counsel. See *supra, at 348-349*.

LEdHN[5][] [5]Respondents also maintain that the result we reach discriminates against insolvent corporations. **[****26]** According to respondents, to prevent the debtor's directors from controlling the privilege amounts to "economic discrimination" given that directors, as representatives of the shareholders, control the privilege for solvent corporations. Brief for Respondents 42; see also *722 F.2d, at 342-343*. Respondents' argument misses the point that, *HN12*[] by definition, corporations in bankruptcy are treated differently from solvent corporations. "Insolvency is a most important and material fact, not only with individuals but with corporations, and with the latter as with the former the mere fact of its existence may change radically and materially its rights and obligations." *McDonald v. Williams, 174 U.S. 397, 404 (1899)*. Respondents do not explain why we should be particularly concerned about differential treatment in this context.

Finally, respondents maintain that upholding trustee waivers would create a disincentive for debtors to invoke the protections of bankruptcy and provide an incentive for creditors to file for involuntary bankruptcy. According to respondents, "[injection] of such considerations into bankruptcy **[*358]** would skew the application **[****27]** of the bankruptcy laws in a manner not contemplated by Congress." Brief for Respondents 43. The law creates numerous incentives, both for and against the filing **[**1996]** of bankruptcy petitions. Respondents do not explain why our holding creates incentives that are inconsistent with congressional intent, and we do not believe that it does.

VII

LEdHN[1D][] [1D]For the foregoing reasons, we hold that the trustee of a corporation in bankruptcy has the power to waive the corporation's attorney-client privilege with respect to prebankruptcy communications. We therefore conclude that Notz, in his capacity as trustee, properly waived CDCB's privilege in this case. The judgment of the Court of Appeals for the Seventh Circuit is accordingly reversed.

It is so ordered.

JUSTICE POWELL took no part in the consideration or decision of this case.

References

9 Am Jur 2d, Bankruptcy 150, *151*

81 Am Jur 2d, Witnesses 223

5 Federal Procedure, L Ed, Bankruptcy 9:74 et seq.

11 USCS 542(e)

US L Ed Digest, Bankruptcy 38, 165 168; Corporations 97, 197; Evidence 706

L **[****28]** Ed Index to Annos, Attorney and Client; Bankruptcy; Evidence; Privileged Communications

ALR Quick Index, Bankruptcy or Insolvency; Privileged and Confidential Matters

Federal Quick Index, Bankruptcy; Privileged Communications

Annotation References:

Under what circumstances can corporation claim privilege for communications from its employees and agents to corporation's attorney. *9 ALR Fed 685*

Privileged communications between accountant and client. *33 ALR4th 539*.

Power of trustee in bankruptcy to waive privilege of communications available to bankrupt. *31 ALR3d 557*.

End of Document

Morand v. Superior Court

Court of Appeal of California, First Appellate District, Division One

April 3, 1974

Civ. Nos. 34304, 34493

Reporter
38 Cal. App. 3d 347 *; 113 Cal. Rptr. 281 **; 1974 Cal. App. LEXIS 1057 ***

WALTER MORAND et al., Petitioners, v. THE SUPERIOR COURT OF THE CITY AND COUNTY OF SAN FRANCISCO, Respondent; MONROE MORRIS, as Receiver, etc., Real Party in Interest. K & E RENTALS, INC., et al., Petitioners, v. THE SUPERIOR COURT OF THE CITY AND COUNTY OF SAN FRANCISCO, Respondent; MONROE MORRIS, as Receiver, etc., Real Party in Interest

Subsequent History: [*1]** A petition for a rehearing was denied May 3, 1974, and the petition of the real party in interest for a hearing by the Supreme Court was denied May 29, 1974.

Disposition: The peremptory writs of mandate will issue.

Core Terms

receiver, appointment, judgment debtor, proceedings, aid of execution, receivership, commencement of the action, judgment creditor

Case Summary

Procedural Posture
Petitioner corporations objected, by way of demurrers, to the jurisdiction of a trial court (California) to entertain respondent receiver's action against them. The demurrers were overruled, and petitioners sought peremptory writs of mandate directing that their demurrers be sustained without leave to amend.

Overview

Respondent receiver was appointed receiver in aid of execution under *Cal. Civ. Proc. Code § 564(4)* after a money judgment against another party went unsatisfied. Respondent filed suit against petitioner corporations for declaratory relief and petitioners objected by way of demurrers. The trial court overruled the demurrers and petitioners sought peremptory writs of mandate directing that their demurrers be sustained without leave to amend. The court held that the trial court had erred and issued the writs. The court stated that the trial court's order permitting employment of an attorney for the purpose of taking whatever action necessary to obtain possession of the property, which gave questionable authority to sue one defendant, the party against whom the money judgment was entered, fell far short of leave to commence an action against petitioners. The court added that the although the trial court's order stated that the attorney could do all things necessary to enable the receiver to effectively carry out the responsibilities of his receivership, it gave no special or express permission to commence an action against petitioners.

Outcome
The court issued the peremptory writs and held that applying the pertinent rules, respondent receiver had no legal authority to commence his action against petitioner

corporations in the mandate proceedings, and that accordingly the trial court was without jurisdiction to entertain the action. The court stated that it was error for the trial court to overrule the demurrers.

LexisNexis® Headnotes

Bankruptcy Law > Procedural Matters > State Insolvency Laws

Civil Procedure > ... > Receiverships > Receivers > Appointment of Receivers

Civil Procedure > Judgments > Enforcement & Execution > General Overview

Civil Procedure > Judgments > Enforcement & Execution > Writs of Execution

Civil Procedure > Remedies > Receiverships > General Overview

HN1[] **Procedural Matters, State Insolvency Laws**

It has been a long standing judicial practice, in proper cases, to appoint receivers in proceedings variously called in aid of execution, supplemental proceedings, creditors' suits, and creditors' bills. The purpose of such proceedings is to reach property of a judgment debtor that may not be reached by the ordinary levy of execution. Unlike receivers generally whose true origin is in equity, receivers in aid of execution are considered creatures of statute. A receivership in proceedings supplementary to execution is a creation of statute and not a remedy in equity. The receiver is not, except in a technical sense, an officer or instrumentality of the court, but represents and is an agent of the judgment debtor, the judgment creditor at whose instance he was appointed, and such other judgment debtors as may have caused the receivership to be extended to their claims.

Bankruptcy Law > Procedural Matters > State Insolvency Laws

Civil Procedure > ... > Receiverships > Receivers > Appointment of Receivers

Civil Procedure > Judgments > Enforcement & Execution > General Overview

Civil Procedure > Remedies > Receiverships > General Overview

Civil Procedure > ... > Receiverships > Receivers > General Overview

Civil Procedure > Appeals > Standards of Review > Abuse of Discretion

HN2[] **Procedural Matters, State Insolvency Laws**

The appointment of a receiver rests wholly within the judicial discretion, and upon appointment he is subject to the continued direction and control of the court. The appointment may be made where there are reasonable grounds to believe that the judgment debtor, or third parties, have control of property which rightfully should be subject to execution. Upon his appointment the receiver has no greater rights against others than the judgment creditor would have. And in a proper case, when authorized by the court or by statute, such a receiver may maintain an action to effect the purpose of the receivership. But it must be borne in mind that the power to appoint a receiver is a delicate one which is exercised sparingly and with caution, and only in an extreme case under such circumstances as demand or require summary relief, and never in a doubtful case or where there is no necessity or occasion for the appointment.

Bankruptcy Law > Procedural Matters > State Insolvency Laws

Civil Procedure > ... > Receiverships > Receivers > Appointment of Receivers

Civil Procedure > Judgments > Entry of Judgments > General Overview

Civil Procedure > Judgments > Enforcement & Execution > General Overview

Civil Procedure > Judgments > Enforcement & Execution > Writs of Execution

Civil Procedure > Remedies > Receiverships > General Overview

Civil Procedure > ... > Receiverships > Receivers > General Overview

HN3[] Procedural Matters, State Insolvency Laws

Cal. Civ. Proc. Code § 564(4) authorizes appointment of a receiver, providing, after judgment, in proceedings in aid of execution, when an execution is been returned unsatisfied, or when the judgment debtor refuses to apply his property in satisfaction of the judgment. Cal. Code Civ. Proc. § 568 provides that the receiver has, under the control of the court, power to bring and defend actions in his own name, as receiver. The power to appoint receivers "in aid of execution" has been recognized by the state's courts, and the right of such a receiver to bring and defend actions has also been judicially recognized.

Bankruptcy Law > Procedural Matters > State Insolvency Laws

Civil Procedure > ... > Receiverships > Receivers > Appointment of Receivers

Civil Procedure > Remedies > Receiverships > General Overview

Civil Procedure > ... > Receiverships > Receivers > General Overview

HN4[] Procedural Matters, State Insolvency Laws

California rigidly adheres to the principle that the power to appoint a receiver is a delicate one which is to be exercised sparingly and with caution. It is said by the state's courts that the appointment of a receiver is an extraordinary and harsh, and delicate, and drastic, remedy to be used cautiously and only where less onerous remedies would be inadequate or unavailable. And a party to an action should not be subjected to the onerous expense of a receiver, unless his appointment is obviously necessary to the protection of the opposite party.

Bankruptcy Law > Procedural Matters > State Insolvency Laws

Civil Procedure > ... > Receiverships > Receivers > Appointment of Receivers

Civil Procedure > Remedies > Receiverships > General Overview

Civil Procedure > ... > Receiverships > Receivers > General Overview

Civil Procedure > ... > Receiverships > Receivers > Powers of Receivers

HN5[] Procedural Matters, State Insolvency Laws

The functions and powers of a receiver are controlled by statute, by the order appointing him, and by orders subsequently made by the court. He has no powers beyond those so conferred. This rule is given particular effect with regard to actions sought to be commenced by the receiver. He may commence such an action only by authority of statute or the "special" or "express" permission of the court that appointed him.

Civil Procedure > Parties > Capacity of Parties > General Overview

Real Property Law > Title Quality > Adverse Claim Actions > Quiet Title Actions

Civil Procedure > Judgments > Enforcement & Execution > General Overview

HN6[] Parties, Capacity of Parties

See Cal. Civ. Proc. Code § 720.

Headnotes/Summary

Summary
CALIFORNIA OFFICIAL REPORTS SUMMARY

The trial court overruled the demurrers of certain defendants in an action brought by a receiver in aid of execution. The receiver sought a declaration that a sublease, in which the demurring defendants and others allegedly claimed an interest, was the sole property of the judgment debtor. The receiver had secured an order authorizing him to employ an attorney for the purpose of taking whatever action might become necessary to obtain possession of property in the possession of another defendant, and to do all other things necessary to enable the receiver to effectively carry out the responsibilities of his receivership.

The Court of Appeal ordered issuance of peremptory writs of mandate, holding that the receiver had no legal authority to commence the action against the demurring defendants and that it was error to overrule the demurrers. The court cited the rule that the functions and powers of a receiver are controlled by statute, by the order appointing him, and by orders subsequently made by the court, and that he has no powers beyond those so conferred. It was further noted that the rule is given particular effect with regard to actions sought to be commenced by a receiver. The court viewed the order authorizing employment of the attorney as falling far short of leave to commence an action against four parties not named therein, and it did not regard the additional "all things necessary" clause as conferring any official or express permission to commence an action against them. (Opinion by Elkington, J., with Molinari, P. J., and Sims, J., concurring.)

Headnotes
CALIFORNIA OFFICIAL REPORTS HEADNOTES

Classified to McKinney's Digest

CA(1)[] **(1)**

Executions § 125—Supplementary Proceedings—Receiver.

--Unlike receivers generally, whose true origin is in equity, a receiver in aid of execution is considered a creature of statute. He is not, except in a technical sense, an officer or instrumentality of the court, but represents and is an agent of the judgment debtor, the judgment creditor at whose instance he was appointed, and such other judgment creditors as may have caused the receivership to be extended to their claims.

CA(2)[] **(2)**

Executions § 125 — Supplementary Proceedings—Receiver.

--The appointment of a receiver in aid of execution rests wholly within the judicial discretion, and upon appointment the receiver is subject to the continued discretion and control of the court, but the power to appoint a receiver is a delicate one which is exercised sparingly and with caution, and only in extreme cases under circumstances as demand or require summary relief, and never in a doubtful case or where there is no necessity or occasion for the appointment.

CA(3)[] **(3)**

Receivers § 67—Powers, Duties and Liabilities.

--The rule that the functions and powers of a receiver are controlled by statute, by the order appointing him, and by orders subsequently made by the court, and that he has no powers beyond those so conferred, is given particular effect with regard to actions sought to be commenced by the receiver. He may commence such an action only by authority of statute or the "special" or "express" permission of the court which appointed him.

CA(4)[] **(4)**

Executions § 125 — Supplementary Proceedings — Receiver — Authority to Bring Actions.

--The trial court erred in overruling the demurrers of two corporations and two individuals sued by a receiver in aid of execution, where the only conceivable authority of the receiver for the bringing of the action was an order permitting employment of an attorney for the purpose of taking whatever action might become necessary to obtain possession of property in the possession of another corporation. The authority to sue one defendant, for which scant basis appeared, fell far short of leave to commence an action against four parties not named in the order, and additional language of the order "and to do all things necessary to enable the receiver to effectively carry out the responsibilities of his receivership," gave no "special" or "express" permission to commence an action against them.

Counsel: David A. Norwitt, Harlem, Nevin & Sarrail, Robert A. Harlem, David W. Brennan and John Russell for Petitioners.

No appearance for Respondent.

Robert J. Cort for Real Party in Interest.

Judges: Opinion by Elkington, J., with Molinari, P. J., and Sims, J., concurring.

Opinion by: ELKINGTON

Opinion

ELKINGTON

[*349] [282]** We have consolidated for hearing and decision two closely related applications for relief by way of mandate. They deal with the power of the superior courts to appoint receivers in aid of execution, and the power of such receivers to commence actions in relation to the receivership.

HN1[] It has been a long standing judicial practice, in proper cases, to appoint receivers in proceedings variously called "in aid of execution," "supplemental proceedings," "creditors' suits," and "creditors' bills." The purpose of such proceedings is to **[**283]** reach property of a judgment debtor which may not be reached by the ordinary levy of execution. *CA(1)*[] **(1)** Unlike receivers generally whose **[***2]** true origin is in equity (see 42 Cal.Jur.2d, Receivers, § 3; *65 Am.Jur.2d, Receivers, § 1*), receivers in aid of execution are considered creatures of statute. Their nature is pointed up from a wide collection of authority, q.v., by Corpus Juris Secundum, Volume 33, in its **[*350]** article on Executions, section 385, as follows: "A receivership in proceedings supplementary to execution is a creation of statute and not a remedy in equity. The receiver is not, except in a technical sense, an officer or instrumentality of the court, but represents and is an agent of the judgment debtor, the judgment creditor at whose instance he was appointed, and such other judgment debtors [*sic*] as may have caused the receivership to be extended to their claims."

CA(2)[] **(2)** *HN2*[] The appointment of such a receiver rests wholly within the judicial discretion, and upon appointment he is subject to the continued direction and control of the court. The appointment may be made where there are reasonable grounds to believe that the judgment debtor, or third parties, have control of property which rightfully should be subject to execution. Upon his appointment the receiver has no greater rights against others **[***3]** than the judgment creditor would have. And in a proper case, when authorized by the court or by statute, such a receiver may maintain an action to effect the purpose of the receivership. (See generally: 33 C.J.S., Executions, §§ 384-393; 21 C.J.S., Creditors' Suits, § 63; 30 Am.Jur.2d, Executions, §§ 851-858; and see authority in these works collected.)

But it must be borne in mind that "[the] power to appoint a receiver is a delicate one which is exercised sparingly and with caution, and only in an extreme case under such circumstances as demand or require summary relief, and never in a doubtful case or where there is no necessity or occasion for the appointment." (75 C.J.S., Receivers, § 15; see also 33 C.J.S., Executions, § 386, subd. d; 30 Am.Jur.2d, Executions, §§ 851-853; and see authority in these works collected.)

California follows the general rules we have discussed. *HN3*[] *Code of Civil Procedure section 564, subdivision 4*, has since 1933 authorized appointment of a receiver: "After judgment, . . . in proceedings in aid of execution, when an execution has been returned unsatisfied, or when the judgment debtor refuses to apply his property in satisfaction of the judgment; **[***4]** . . ." *Section 568* of the same code provides that: "The receiver has, under the control of the court, power to bring and defend actions in his own name, as receiver; . . ." The power to appoint receivers "in aid of execution" had been recognized by the state's courts. (See *Bruton v. Tearle, 7 Cal.2d 48, 56 [59 P.2d 953, 106 A.L.R. 580]*; *In re Ferguson, 123 Cal.App.2d 799, 804 [268 P.2d 71]*; *Tucker v. Fontes, 70 Cal.App.2d 768 [161 P.2d 697]*; *Elson v. Nyhan, 45 Cal.App.2d 1, 4-5 [113 P.2d 474]*;

Medical F. Assn. v. Short, 36 Cal.App.2d Supp. 745 [92 P.2d 961]; 19 Cal.Jur.2d, Rev., Executions, § 233.) And the right of such a receiver to bring and defend actions has also been judicially recognized. (Tucker v. Fontes, supra, p. 773.)

[*351] But we find it important to note that **HN4**[] California rigidly adheres to the principle that the power to appoint a receiver is a delicate one which is to be exercised sparingly and with caution. It is said by the state's courts that the appointment of a receiver is "an extraordinary and harsh," and "delicate," and "drastic," remedy to be used "cautiously and only where less onerous remedies would **[***5]** be inadequate or unavailable. . . ." (See Cohen v. Herbert, 186 Cal.App.2d 488, 495 [8 Cal.Rptr. 922]; Alhambra etc. Mines v. Alhambra G. Mine, 116 Cal.App.2d 869, 873 [254 P.2d 599]; Dabney Oil Co. v. Providence Oil Co., 22 Cal.App. 233, 238, 239 [133 P. 1155]; 42 Cal.Jur.2d, Receivers, § 9.) And a party to an action should not be "subjected **[**284]** to the onerous expense of a receiver, unless . . . his appointment is obviously necessary to the protection of the opposite party. . . ." (De Leonis v. Walsh, 148 Cal. 254, 255 [82 P. 1047].)

CA(3)[] **(3)** It is the rule that: "**HN5**[] The functions and powers of a receiver are controlled by statute, by the order appointing him, and by orders subsequently made by the court. He has no powers beyond those so conferred." (42 Cal.Jur.2d, Receivers, § 73; and see authority there collected.) This rule is given particular effect with regard to actions sought to be commenced by the receiver. He may commence such an action only by authority of statute or the "special" or "express" permission of the court which appointed him. (See Code Civ. Proc., § 568; Scott v. Hollingsworth, 215 Cal. 314, 316 [9 P.2d 836, **[***6]** 82 A.L.R. 995]; Bishop v. McKillican, 124 Cal. 321, 325-326 [57 P. 76]; Tibbets v. Cohn & Co., 116 Cal. 365, 367 [48 P. 372]; 3 Witkin, Cal. Procedure (2d ed. 1971) Pleading, § 116; 42 Cal.Jur.2d, Receivers, §§ 89, 90.)

We end this dissertation and proceed with our analysis of the problems presented to us.

Scott Electric Company had obtained a money judgment against a corporation named Far East Exports. The judgment was unsatisfied, after return of execution and summary proceedings.

Thereafter, upon notice and hearing, one Monroe Morris was in the same action, appointed receiver in aid of execution under Code of Civil Procedure section 564, subdivision 4. His authority, spelled out in the order and as relevant here, was (1) to "take over any and all assets of the judgment debtor herein and to take all necessary action to reduce the same to possession," and (2) to "collect any rents due and hereafter to become due from tenants or sublessees of said judgment debtor."

Thereafter Monroe Morris as such receiver represented to the court that Western Tri-Pack Corporation and Surgical Plastic Products, Inc., **[*352]** had possession of or were claiming certain **[***7]** "assets, to wit, rental to be paid the judgment debtor." On application therefor the court authorized the receiver to employ a designated attorney "as his attorney for the purpose of taking whatever action may become necessary to obtain possession of the property now in the possession of Western Tri-Pack Corporation, and to do all other things necessary to enable [the receiver] to effectively carry out the responsibilities of his receivership."

The receiver thereupon commenced an action for "Declaratory Relief" against the judgment debtor, Far East Exports, Western Tri-Pack Corporation, and, among others, the previously unmentioned four petitioners in the mandate proceedings before us, Walter Morand, Surgical Plastic Products, Inc., K. L. Kleinen and K & E Rentals, Inc.

The action sought a judicial declaration that a certain sublease in which the defendants allegedly claimed an interest was the property solely of the judgment debtor Far East Exports; and further, that certain of the defendants were "each the alter-ego of the other." Although compensatory damages were not sought, punitive damages of $ 25,000 were.

The defendants below and petitioners here, Walter Morand, Surgical **[***8]** Plastic Products, Inc., K. L. Kleinen and K & E Rentals, Inc., objected, by way of demurrers, to the jurisdiction of the superior court to entertain the receiver's action against them. The demurrers having been overruled, they sought from this court peremptory writs of mandate directing that their demurrers be sustained without leave to amend. We issued alternative writs of mandate directed to the superior court.

We first observe that **HN6**[] Code of Civil Procedure section 720 provides that when "it appears that a person or corporation, alleged to have property of the judgment debtor, or to be indebted to him, claims an interest in the property adverse to him, or denies the debt, the judgment creditor may maintain an action against such person or corporation for the recovery of such interest or debt; . . ." And certainly, in **[**285]** such an action, the judgment creditor himself could establish that third parties claiming interest in the property, or denying the debt, were but the *alter egos* of the judgment debtor. For these reasons there would seem to have been scant reason for the court in the exercise of its judicial discretion, to authorize the receiver to commence the action; **[***9]** no reason was shown why it should not have been brought by the judgment creditor under *Code of Civil Procedure section 720*.

CA(4)[] **(4)** But the central question before us is whether the receiver was, in any event, authorized to bring the action against the several petitioners in the proceedings now before this court.

[*353] As pointed out, the only conceivable authority of the receiver for the *bringing of the action* was the court's order permitting employment of an attorney "for the purpose of taking whatever action may become necessary to obtain possession of the property now in the possession of Western Tri-Pack Corporation." This questionable authority to sue one defendant falls far short of leave to commence an action against the there unnamed four parties who are the petitioners before us. The order's additional language, "and to do all things necessary to enable the receiver to effectively carry out the responsibilities of his receivership," gave no "special" or "express" permission to commence an action against them. Indeed, if one were to assume that it did, then the court would have improperly relinquished to the receiver the discretion whether an action might be commenced, **[***10]** and if so, against whom.

Applying the pertinent rules we hold that the receiver had no legal authority to commence his action against the petitioners in these mandate proceedings; and that accordingly the superior court was without jurisdiction to entertain the action. It was error to overrule the demurrers.

The peremptory writs of mandate will issue.

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