



## Effects of Veil Piercing, Alter Ego and Substantive Consolidation on Bankruptcy

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### Introduction

At times, bankruptcy can seem like a game of cat and mouse between debtors and creditors. By filing for bankruptcy in the first place, debtors change the rules of the game with various bankruptcy mechanisms, such as the automatic stay provision set forth in section 361 of the United States Bankruptcy Code (the "Bankruptcy Code").<sup>1</sup> An important inquiry exists in what creditors can do to promote their interests in bankruptcy. An even more important inquiry lies in determining what doctrines may satisfy generally recognized principles of equity for all.

One option for creditors who deal with corporate entities is to assert a veil piercing theory in order to obtain access to more assets. According to established legal principles, corporations are recognized as legal entities, separate and distinct from their shareholders and managers. The debts and obligations of the corporation are the responsibility of the corporate entity, not the shareholders, who are liable only for the amount they voluntarily put at risk by investing it into the business. When the incentive value of limited liability is outweighed by the competing factor of basic fairness to parties dealing with corporations, courts may pierce the corporate veil and

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<sup>1</sup> 11 U.S.C. § 361.

hold the owners, shareholders, or members personally liable for the debts of the corporation.<sup>2</sup>

Some factors courts consider when deciding whether to pierce the corporate veil or not are whether corporate formalities were adhered to, inadequate capitalization, and movement of funds for personal purposes.<sup>3</sup> Courts may also pierce the corporate veil in the event of fraud.<sup>4</sup>

Another legal theory that is very similar to a veil piercing claim is an alter ego claim. In order to prevail on an alter ego claim, a corporate entity must be so dominated by an individual and its separate entity so ignored that it primarily transacts the dominator's business instead of its own and can be called the other's "alter ego."<sup>5</sup> Outside of a bankruptcy context, most practitioners pay little attention to the differences between corporate veil piercing and alter ego claims because the practical implications of each are the same. In both cases, the plaintiff gains access to the assets of another entity in addition to those of the defendant to satisfy the judgement.<sup>6</sup> However, as the case law has developed, there seems to be a more notable distinction between whether a litigant asserts a veil piercing or alter ego theory in bankruptcy.<sup>7</sup>

Nevertheless, a veil piercing or alter ego claim may not always be a viable option for all creditors and debtors. Another theory that is often used in the bankruptcy context is substantive consolidation. Substantive consolidation is the pooling of the assets and liabilities of technically

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<sup>2</sup> See Barber, *Piercing the Corporate Veil*, 17 Willamette L. Rev. 371, 398 (1981).

<sup>3</sup> See *In re Saba Enters.*, 421 B.R. 626, 650 (Bankr. S.D.N.Y. 2009).

<sup>4</sup> *Id.*

<sup>5</sup> See *Rohmer Assocs., Inc. v. Rohmer*, 36 A.D.3d 990, 991 (3d Dep't 2007).

<sup>6</sup> See Evan C. Hollander, *Beware Distinctions Between Veil Piercing And Alter Ego*, Law360, May 13, 2015, <https://www.law360.com/newyork/articles/654425/beware-distinctions-between-veil-piercing-and-alter-ego>; see also *Wm. Passalacqua Builders v. Resnick Developers S.*, 933 F.2d 131, 138 (2d Cir. 1991) (using the terms "veil piercing" and "alter ego" interchangeably).

<sup>7</sup> See *Mokuba N.Y. LLC v. Pitts (In re Pitts)*, 2009 Bankr. LEXIS 4023 (U.S. Bankr. E.D.N.Y. Dec. 8, 2009) (finding that post-petition state court proceedings may be a violation of automatic stay if plaintiffs were to successfully pierce the corporate veil due to immediate adverse effect on debtor). Compare with *Agai v. Mihalatos (In re Mihalatos)*, 527 B.R. 55, 59-60 (Bankr. E.D.N.Y. 2015) ("Although in New York, the concepts of piercing the corporate veil and a finding of alter ego have routinely been equated, possibly because under some recitations of the standard an 'alter ego' finding is subsumed in a 'piercing' finding, they are not necessarily the same and do not necessarily have the same consequences.").

distinct corporate entities. For the purposes of confirming a Chapter 11 plan or for liquidating assets under Chapter 7, the creditors of the previously distinct subsidiaries are creditors of a single debtor. Although courts use language reminiscent of “piercing the corporate veil,” the doctrines are quite distinct—instead of pooling assets vertically (e.g., parent and subsidiary), substantive consolidation pools assets horizontally (e.g., subsidiary and subsidiary).<sup>8</sup> Substantive consolidation is based strictly on equity, and there are no statutorily prescribed standards. In the absence of set standards, courts have developed various guidelines, all of which turn on the facts of the specific case at hand.<sup>9</sup>

This memorandum will explore these related, yet significantly distinct, legal theories and when they are most appropriate to use in bankruptcy. Parts I and II will briefly discuss two corporate law constructs, veil piercing and alter ego claims, respectively, and how they may fit into the bankruptcy scheme. Part III will conclude the with an in-depth discussion of substantive consolidation, the most used of these doctrines in bankruptcy, and its implications for both debtors and creditors.

## **I. Veil Piercing Under Common Law Principles of Corporate Law**

The concept of piercing the corporate veil is a limitation on the accepted notion that a corporation exists independently of its owners, as a separate legal entity, that the owners are generally not liable for the debts of the corporation, and that it is legal to incorporate for the purpose of limiting the liability of the corporate owners.<sup>10</sup> The doctrine of piercing the corporate veil is normally used by a third party seeking to penetrate the corporate existence in

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<sup>8</sup> See e.g., Andrew Brasher, *Substantive Consolidation: A Critical Examination*, 2006, [http://www.law.harvard.edu/programs/corp\\_gov/papers/Brudney2006\\_Brasher.pdf](http://www.law.harvard.edu/programs/corp_gov/papers/Brudney2006_Brasher.pdf).

<sup>9</sup> 2 *Collier on Bankruptcy*, ¶105.09[2], pp. 105-88 to 105-89 (Alan N. Resnick & Henry J. Somers eds., 15th ed. rev. 2004).

<sup>10</sup> *Morris v. State Dep’t of Taxation & Fin.*, 82 N.Y.2d 135, 140.

order to evade the limited liability of the owners and to hold them liable for some underlying corporate obligation.<sup>11</sup>

“Piercing the corporate veil” is not necessarily a bankruptcy concept and the phrase does not appear in the Bankruptcy Code. Rather, it is a state-law equitable remedy for combining corporate entities with their primary shareholders to enable litigants to recover money from them.<sup>12</sup> Typically, creditors will sue business entities and their owners in state court first and ask the court to execute the veil piercing doctrine.<sup>13</sup> After that, many times either the corporation or the owners will file bankruptcy.<sup>14</sup> The state court case is then removed to the bankruptcy court, which applies state law to the piercing issue.<sup>15</sup> If the creditors win, they will usually move the bankruptcy court to hold the debts owed by the debtor-owners as non-dischargeable.<sup>16</sup>

Usually courts will respect the corporate structure of limited liability unless there are good reasons to pierce the veil in the interest of justice and equity.<sup>17</sup> Because many times a debtor, especially a closely held corporation or LLC, may be unable to pay debts directly out of its business assets, a creditor may seek to assert alter ego claims to obtain a new source of funds to satisfy its debts. If a corporate debtor is solvent and paying debts as they become due in the ordinary course, there would be no need to pierce the corporate veil in this context.

*A. Music Mix Mobile Case – A Case Illustration where Veil Piercing May Work*

In *Music Mix Mobile, LLC v. Newman (In re Stage Presence, Inc.)*, the United States Bankruptcy Court for the Southern District of New York held that the plaintiff’s veil

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<sup>11</sup> *Id.* at 140-41.

<sup>12</sup> *See generally id.*

<sup>13</sup> *See In re Pitts*, 2009 Bankr. LEXIS 4023 at \*3-\*6 (showing an example of what typically happens).

<sup>14</sup> *Id.* at \*7.

<sup>15</sup> *Id.*

<sup>16</sup> *See* 11 U.S.C. § 523.

<sup>17</sup> *Official Comm. of Unsecured Creditors v. Bay Harbour Master Ltd. (In re BH S&B Holdings LLC)*, 420 B.R. 112, 133 (Bankr. S.D.N.Y. 2009).

piercing/alter ego allegations were sufficient to withstand a defendant's motion to dismiss.<sup>18</sup> This case arose due to a television show broadcasted in May 2010 to benefit a charity called Childhelp. Plaintiffs, Music Mix Mobile, alleged that they were not paid by defendants for audio, editing, teleprompter, music mixing and other services they provided in connection with the program.<sup>19</sup> The defendants in this case included Stage Presence Incorporation (a chapter 11 debtor), One for Each Island Ltd. ("OFEI") and three individual producers of the benefit program: Newman, Weiner, and Marquette. Plaintiffs alleged that OFEI may have never actually existed.<sup>20</sup> Among other theories of contract liability against defendants, plaintiffs asserted that OFEI, Newman, Weiner, and Marquette should jointly share in the contract liabilities of Stage Presence on veil piercing/alter ego grounds.<sup>21</sup>

Music Mix Mobile asserted three separate theories of contract liability in their complaint against OFEI, Newman, Weiner, and Marquette, but because the defendants filed a motion to dismiss, the court had to decide which claims, if any, were sufficient to allow the case to proceed. One theory plaintiffs prevailed on was their alter ego/veil piercing claim.<sup>22</sup> The court noted that piercing the corporate veil requires a showing that "(1) the owners exercised complete domination of the corporation in respect to the transaction attacked; and (2) that such domination was used to commit a fraud or wrong against the plaintiff which resulted in plaintiff's injury."<sup>23</sup> The court found that allegations in the complaint were sufficient to withstand defendant's motion to dismiss the claim.

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<sup>18</sup> 555 B.R. 166 (Bankr. S.D.N.Y. 2016).

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> *Id.* at 171.

<sup>22</sup> *Id.* at 180

<sup>23</sup> *Id.* at 176.

In *Music Mix Mobile*, like in *Passalacqua Builders*, 933 F.2d at 138, terms referring to “veil piercing” and “alter ego” are used interchangeably by the court, but refer to the general notion of holding an individual liable for the debts of the corporate defendant.<sup>24</sup> When a court is considering a motion to dismiss, the distinction may not be as important, but as we will see, there can be implications for a debtor’s automatic stay dependent on whether a litigant asserts a veil piercing or alter ego claim.<sup>25</sup>

## II. Effects of Alter Ego Claims on Bankruptcy

The alter ego doctrine, like the veil piercing doctrine, arises when a litigant claims that an opposing party is using the corporate form unjustly and contrary to the litigant’s interests, and thus the court should not maintain the “fiction” of a separate legal entity. In certain circumstances, courts will disregard the corporate entity and will hold individual owners liable for the corporation’s actions. The main test used to determine whether a corporate presence is an alter ego is the “instrumentality rule.”<sup>26</sup> Under the instrumentality rule, the inquiry is whether the business owner has completely dominated the business and used the corporation as an instrumentality to do his or her personal business. If that question is answered affirmatively and the owner’s conduct has harmed an innocent third party, the court may conclude that the corporation is the owner’s alter ego, and may hold the owner responsible for the debts of the corporation. In *Rohmer Associates v. Rohmer*, the court held that where a “corporate entity has been so dominated by an individual . . . and its separate entity so ignored that it primarily

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<sup>24</sup> See *Music Mix Mobile*, 555 B.R. at 174-73. (“However, one of the forms of relief that Plaintiffs seek is an order that would pierce the corporate veil and that would hold one or more other defendants liable for the debts owed by Stage Presence. It is well established that a ‘[c]laim for the imposition of liability against a defendant that rests upon allegations that such defendant is liable to the plaintiff because it is an alter ego of another entity who has not been joined as a defendant, renders the non-joined entity a necessary party.’”).

<sup>25</sup> . See *In re Mihalatos*, 527 B.R. at 59-60.

<sup>26</sup> See *Lowendahl v. Baltimore & Ohio R.R. Co.*, 247 A.D. 144, 156 (1st Dep’t), aff’d, 272 N.Y. 360 (1936).

transacts the dominator's business instead of its own and can be called the other's alter ego, the corporate form may be disregarded to achieve an equitable result."<sup>27</sup>

Both alter ego and veil piercing can be used against individuals as well as other corporations. In *Music Mix Mobile*, the plaintiff sought to pierce the corporate veil of the debtor, Stage Presence, by implicating both individual defendant Newman and another limited liability entity owned by Newman, OFEI.<sup>28</sup> Generally, the alter ego doctrine applies in New York when affiliate or subsidiary corporations are used by a dominating parent corporation to engage in wrongful conduct. As stated by the court in *Trabucco v. Intesa Sanpaolo, S.p.A.*, “[u]nder New York Law, one corporation is considered to be mere alter ego when it ‘has been so dominated by . . . another corporation . . . and its separate identity so disregarded, that it primarily transacted the dominator's business rather than its own.’ . . . Then, the dominating corporation will be held liable for the actions of its subsidiary . . . Alter ego cases typically involve the determination of “which corporate parties may be cast in damages for the breach” of a contract. . . . In this analysis, control is the key.”<sup>29</sup>

The following are factors considered by the courts in New York in determining whether the alter ego doctrine should be used to connect corporate entities: the absence of corporate formalities such as issuance of stock, election of directors, etc.; inadequate capitalization; whether funds are put in and taken out of the corporation for personal rather than corporate purposes; overlap in ownership, officers, directors and personnel; common office space, address and telephone number for the corporate entities; the amount of business discretion displayed by the allegedly dominated corporation; whether the related corporations deal with the dominated corporation at arm's-length; whether the corporations are treated as independent profit centers;

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<sup>27</sup> 36 A.D.3d 990, 991 (3d Dep't 2007).

<sup>28</sup> See *Music Mix Mobile*, 555 B.R. at 171.

<sup>29</sup> 695 F. Supp. 2d 98, 107 (S.D.N.Y. 2010).

the payment or guarantee of debts of the dominated corporation by other corporations in the corporate group; whether the dominating corporation in question uses property owned by the dominated corporation as if it were its own.<sup>30</sup> It is important to recognize that no one factor is dispositive and “all need not be present to support a finding of alter ego status.”<sup>31</sup> At least some courts have noted a distinction between asserting piercing the corporate veil claims and alter ego claims, especially in a bankruptcy context.<sup>32</sup>

### **III. Substantive Consolidation – A Bankruptcy Equity Principle**

Generally, when a litigant makes a motion for substantive consolidation, he or she moves the court to consolidate the assets and liabilities of several fully owned subsidiaries into their parent companies and into each other. In a Chapter 7 liquidation case, multiple asset and liability pools are reduced to a single pool and payments are made according to a claim’s priority in that pool. In a Chapter 11 reorganization case, class voting, classification of claims, and cram down are all determined on the basis of the combined entities and, when the entities finish their Chapter 11 reorganization, they do so as a single corporation.<sup>33</sup> This situation is the classic

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<sup>30</sup> See *Passalacqua Builders, Inc.*, 933 F.2d at 139 (listing these factors).

<sup>31</sup> *N.Y. Dist. Council of Carpenters Pension Fund v. Perimeter Interiors, Inc.*, 657 F. Supp. 2d 410, 421 (S.D.N.Y. 2009). See generally Edward P. Yankelunas, *The Alter Ego Article Doctrine in New York*, NYSBA Journal, 10-15 (May 2015).

<sup>32</sup> See *in re Mihalatos*, 527 B.R. 55 at 59-60 (“The case presented now highlights an important distinction between the two concepts and the consequences that flow from each finding: piercing the corporate veil imposes vicarious liability upon an individual for a corporation's debts, while an alter ego finding would make the individual directly liable for the corporate debt by conflating the identities of the two . . . The former would impose liability on the principal while in the context of a bankruptcy the latter would, in addition to broadening the reach of the § 362(a) automatic stay, impose additional disclosure and accountability requirements with respect to the now non-existent corporation, beyond just monetary liability.”).

<sup>33</sup> See generally *In re Continental Vending Machine Corp.*, 517 F.2d 997 (2d. Cir. 1975) (approving substantive consolidation pursuant to a reorganization plan).

example of a substantive consolidation. Nevertheless, bankruptcy courts also have other means in their arsenal to combine formally distinct corporations in more limited ways.<sup>34</sup>

Substantive consolidation is an equitable remedy tailored to each case and, although it has given rise to certain limiting principles, it is still considered an *ultra vires* exercise of a bankruptcy court's power to delineate the bankruptcy estate.<sup>35</sup> Because substantive consolidation often effectuates a redistribution of wealth, creditors of the more solvent estate are the losers in substantive consolidation because the assets of the more solvent estate—that would otherwise be used to satisfy their claims—are diluted by the joinder of the relatively meager assets and large amount of debt associated with the less-solvent estate.<sup>36</sup> Because there can be substantial losers when entities are substantively consolidated, courts have traditionally held that substantive consolidation should only be used sparingly, and only after "a searching inquiry to insure that consolidation yields benefits offsetting any harm it inflicts on objecting parties."<sup>37</sup>

Despite the general conception that substantive consolidation should be used sparingly, in practice it is actually used quite often.<sup>38</sup> In fact, according to an empirical study, substantive consolidation was actually used in over half of the largest public bankruptcy cases filed from

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<sup>34</sup> See generally Andrew Brasher, *Substantive Consolidation: A Critical Examination*, 2006, [http://www.law.harvard.edu/programs/corp\\_gov/papers/Brudney2006\\_Brasher.pdf](http://www.law.harvard.edu/programs/corp_gov/papers/Brudney2006_Brasher.pdf).

<sup>35</sup> *Id.*

<sup>36</sup> *Flora Mir Candy Corp. v. R.S. Dickson & Co.*, 432 F.2d 1060, 1062-63 (2nd Cir. 1970).

<sup>37</sup> *In re Murray Industries Inc.*, 119 B.R. 820, 829 (Bankr. M.D. Fla. 1990). See also, *FDIC v. Colonial Realty Co.*, 966 F.2d 57 (2nd Cir. 1992) ("only through a searching review of the record, on a case-by-case basis, can a court ensure that substantive consolidation effects its sole aim: fairness to all creditors"); Ryan W. Johnson, *The Preservation of Substantive Consolidation*, AUG. 24 AM. BANKR. INST. J. 44 (2005).

<sup>38</sup> See William H. Widen, *Corporate Form and Substantive Consolidation*, 75 GEO. WASH. L. REV. 238, 253 (2007) ("The contrast between the constant caution against widespread use of the doctrine in reported decisions and its common use in negotiated plans of reorganization stands out with particular force because the standard for imposition of substantive consolidation is purported to be the same in both contexts.").

2000-2004.<sup>39</sup> One main reason for this is that it is economically advantageous for parent corporations to create subsidiaries that share officers, directors, and centralized capital raising and cash management activities.<sup>40</sup>

## **Conclusion**

There are many ways that creditors can level the playing field against a corporate debtor in bankruptcy. The results of using veil piecing, alter-ego, and substantive consolidation vary in how they may affect litigants and provisions of the Bankruptcy Code. In New York, as in many jurisdictions, veil piercing and alter ego doctrines are often used interchangeably. However, these two claims could have differing effects on the automatic stay depending on when these issues are raised in litigation.<sup>41</sup> Substantive consolidation is an option that tends to be mismatched in that courts claim it should be used sparingly, yet seem to use it more often. Some scholars have suggested that instead of avoiding substantive consolidation, courts should embrace it and even consider making it the default rule for certain corporate groups and schemes.<sup>42</sup>

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<sup>39</sup> . See William H. Widen, *Prevalence of Substantive Consolidation In Large Bankruptcies From 2000 to 2004: Preliminary Results*, 14 AM. BANKR. INST. L. REV. 47, 59 (2006).

<sup>40</sup> See William H. Widen, *Corporate Form and Substantive Consolidation*, 75 GEO. WASH. L. REV. 238, 257-58 (2007).

<sup>41</sup> 11 U.S.C. § 361.

<sup>42</sup> See William H. Widen, *Corporate Form and Substantive Consolidation*, 75 GEO. WASH. L. REV. 238, 252 (2007) ("The widespread use of the doctrine of substantive consolidation raises the question of whether our corporate law default rule treating each legal entity separately, even when it is a member of a corporate group, should be replaced with a default rule consolidating entities in bankruptcy. If over fifty percent of large corporate reorganizations use substantive consolidation, one might argue that the more efficient default rule would mirror the contract that most parties would negotiate for themselves.").