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WHAT'S INSIDE

SPECIAL FRAUD SECTION

THE ROLE OF ALTER EGO IN RESTRUCTURING

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This past May 2018, the Court of Appeal in Ontario, Canada ruled that Ecuadorean citizens could not enforce a $9.5 billion Ecuadorean court's judgment against Chevron Corp. through its Canadian subsidiary, finding that the subsidiary was a separate corporate entity, and that its assets could therefore not be seized to satisfy a judgment against the parent for contamination from the production of crude oil.[1] Following in August 2018, a federal judge in Delaware ruled that Canadian mining company Crystallex International Corporation ("Chrystallex") could seize shares in Citgo Petroleum Corp. ("CITGO"), which is owned by Venezuelan state-owned oil company Petróleos de Venezuela, S.A. ("PDVSA"), to satisfy a $1.2 billion judgment against Venezuela to compensate for the expropriation of a mining project.[2] The decision in *Chrystallex* in particular is expected to set off a fire storm of litigation as holders of arbitral awards, sovereign bonds, PDVSA bonds and promissory notes jockey for position to be paid. Outcomes, creditors, strategies and geographic differences aside, both claims have in common that they are actions to pierce the corporate veil premised on the theory of alter ego.

General Constructs

The legal distinction between a corporation and its shareholders acts as a "veil" to limit the liability of shareholders to the value of their investment.[3] Notwithstanding, "In certain circumstances, the court will disregard the corporate entity and will hold the individual shareholders liable for the actions of the corporation."[4] "Under Delaware Law, in order to pierce the corporate veil on an alter ego theory, traditionally a plaintiff must prove: (1) the parent and subsidiary operated as a single economic entity; and (2) an overall element of injustice or unfairness

1 Keith Goldberg, *Chevron Escapes $9.5B Ecuadorean Award Bid In Canada*, Law360, May 24, 2018, https://www.law360.com/articles/1047007/chevron-escapes-9-5b-ecuadorean-award-bid-in-canada; Gideon Long and John Paul Rathbone, *Venezuela Creditors Eye Oil Assets In Battle Over Unpaid Debt*, Financial Times, August 16, 2018, https://www.ft.com/content/df04f4ea-a034-11e8-85da-eeb7a9ce36e4

2 Caroline Simson, *Citgo Ruling Has Queued Up Brawl Over Venezuelan Assets*, Law360, August 23, 2018, https://www.law360.com/articles/1076307/citgo-ruling-has-queued-up-brawl-over-venezuelan-assets

3 Stephen M. Bainbridge, Corporate Law, 3rd ed. (St. Paul, MN: Foundation Press, 2015), 53.

4 *Neilson v. Union Bank of Cal., N.A.*, 290 F. Supp. 2d 1101, 1115 (N.D. Cal. 2003) (citing *Mesler v. Bragg Mgmt. Co.*, 39 Cal.3d 290, 300 (1985)).

is present."[5] To do so, "First, there must be such a unity of interest and ownership between the corporation and its equitable owner that the separate personalities of the corporation and the shareholder do not in reality exist. Second, there must be an inequitable result if the acts in question are treated as those of the corporation alone."[6]

Indicia

An action to pierce the corporate veil based on alter ego is an equitable remedy in which the court must find that it would be unfair to *not* disregard the corporation's standing as a separate and distinct legal entity, and allow claimants to obtain a judgment and recovery from its shareholders.[7] To arrive this conclusion, the court requires evidence of the facts and circumstances underlying the claim.

Notwithstanding, the courts have not defined a bright-line test for when alter ego will apply, or reached a consensus as to the identity and relevance of the factors that should be considered. As case law has evolved, however, financial dependence, confusion as to corporate identity, a lack of separateness and domination and control have emerged as the primary indicia of alter ego.[8]

Factors underlying the indicia of financial dependence, lack of separateness and domination and control may include that the corporation lacks adequate capital, is insolvent, or unable to operate as a standalone enterprise, the use of cash management accounts for which the corporation does not pay or receive interest, and related party transactions that benefit the owners or corporation. Confusion as to corporate identity and lack of separateness may be marked by signs including the failure to observe corporate formalities, the use of a common name, trademark, location, IT system and management team, and affirmative misrepresentations regarding the corporation's financial position, expected operating results and entity standing behind its obligations. Domination and control and a lack of separateness may also be indicated by a defacto merger or an unfair preference over other creditors.

The *defacto merger doctrine* is an exception to the generality that an acquirer of assets does not assume the liabilities of the seller unless contractually agreed or through a merger. The four elements that must be shown are (1) a continuation of the seller's enterprise resulting in the continuity of its management, employees, assets and operations, (2) a continuity of shareholders resulting from the buyer paying for the assets acquired with its own shares, with the seller's shareholders subsequently becoming shareholders of the buyer; (3) the seller ceases ordinary operations, liquidates and dissolves as soon as legally and practically possible; and (4) the buyer assumes those liabilities of the seller ordinarily required to maintain the uninterrupted continuation of the seller's business operations. Where all four determinants are present, courts have viewed the successor corporation as nothing more than a continuation of the seller corporation.

Whether a shareholder or parent company has used its controlling position to unfairly favor itself over other holders of interests and claims might also be examined by means of the factors identified in § 547(b) of the Bankruptcy Code. Under § 547(b), a preference may be proven[9] by showing that the debtor transferred an interest in property (1) to or for the benefit of a creditor, (2) for or on account of an antecedent debt, (3) while the debtor was insolvent, (4) on or within 90 days before the debtor filed the petition, or between 90 days and one year prior to the filing of the petition if the creditor was an insider, and (5) the creditor received more than it would have received in a Chapter 7 liquidation, if the transfer had not been made, and if it received payment to the extent provided under the provisions of § 547(b). As applied to the analysis of alter ego, the timing provision of the fourth test may not be relevant in most cases. And while the first, second and third tests may be, they have not been shown necessary for a court to determine alter ego. The fifth condition, however, is dispositive in assessing whether the shareholder or corporation received more than it would have but for the transfer and the corporation were liquidated.

By extension, § 548 of the Bankruptcy Code is similarly useful in analyzing whether a transfer is unfair. As a general matter, fraudulent transfer actions allow creditors to recover pre-petition transfers motivated by actual or constructive fraud by the debtor. In particular, § 548 allows for the avoidance of any transfer of an interest in property, or any obligation incurred, on or within 2 years before the filing of the petition, if the debtor voluntarily or involuntarily (1) made the transfer or incurred the obligation with actual intent[10] to hinder, delay or defraud any entity to which the debtor was or became indebted on or after the date the transfer was made or obligation incurred; or (2) received less than reasonably equivalent value[11] in exchange for the transfer or obligation; and (a) was or became insolvent on the date the transfer was made or obligation incurred, (b) had been or was going to be engaged in a business or transaction for which it had unreasonably small capital; (c) incurred or intended to incur debts exceeding its ability to pay at maturity; or (d) made the transfer to, or incurred the obligation for, the benefit of an insider under an employment contract rather than in the ordinary course of business. As pertains to the analysis of alter ego with a focus on the conduct of a shareholder or parent corporation, the tests concerning

5 *ASARCO LLC, v. Americas Mining Corp.,* 396 B.R. 278, 317 (S.D. Tex. 2008) (citing *In re Foxmeyer Corp.*, 290 B.R. 229, 235 (Bankr. D. Del. 2003)).

6 *Neilson v. Union Bank of Cal.*, N.A., 290 F. Supp. 2d at 1115 (Quoting *Sonora Diamond Corp. v. Superior Court*, 99 Cal. Rptr. 2d 824 (2000)).

7 Daniel G. Lentz, Lynda H. Schwartz, *"Alter Ego" in Litigation Services Handbook, The Role of the Financial Expert,* ed. Roman L. Weil, Daniel G. Lentz and David P. Hoffman. 23.2 – 5th ed. (Hoboken: John Wiley & Sons, Inc., 2012)

8 *Ibid.,* 23.3.

9 Kathy Bazoian Phelps and Steven Rhodes, *The Ponzi Book: A Legal Resource for Unraveling Ponzi Schemes,* 1st ed., §[5.02] (LexisNexis, 2012).

10 *Ibid.,* § [2.01].

11 Daniel G. Lentz, Grant W. Newton, Lynda H. Schwartz, *"The Troubled Business And Bankruptcy" in Litigation Services Handbook, The Role of the Financial Expert*, ed. Roman L. Weil, Daniel G. Lentz and David P. Hoffman. 22.2 – 5th ed. (Hoboken: John Wiley & Sons, Inc., 2012).

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actual intent, the receipt of less than reasonably equivalent value, and making a transfer to or incurring an obligation for the benefit of an insider may be especially relevant.

Fact Patterns

Circumstances that give rise to piercing the corporate veil based on alter ego include (1) the parent or subsidiary are judgment-proof, (2) the corporation is judgment-proof but its shareholders are not, (3) confusion over the corporations identity due to misrepresentation or failure to observe corporate formalities, and (4) the corporation sold assets to avoid a liability, leaving it undercapitalized.[12] The situation where the corporation is judgment-proof but its shareholders are not can arise from a fraudulent transfer, allowing the claimant to seek recovery under the Bankruptcy Code in addition to pursuing equitable relief by establishing that the corporation acted as the alter ego of its owners. The same is true for where a corporation has sold assets to avoid a liability leaving it with inadequate capital, which depending on the transaction structure, may also be deemed a defacto merger.

The Case of Crystallex

In the United States, PDVSA's main asset is CITGO, which it owns through its wholly owned subsidiaries PDV Holding and CITGO Holding, both of which are incorporated in Delaware. In seeking to enforce its judgment against Venezuela ("Republic") from the assets of PDVSA, Crystallex commenced three different causes of action in Delaware.[13] Two of the claims alleged fraudulent transfer, and one, alter ego.

The Fraudulent Transfer Litigation

Perhaps predicated on the awareness of several possible billion-dollar arbitral awards against the Republic, and expecting that the holders could attempt to enforce them against CITGO, in late 2014 and early 2015, CITGO Holding issued roughly $2.8 billion in non-investment grade debt and paid a dividend of approximately the same amount to PDV Holding. PDV Holding then paid PDVSA, in Venezuela, a dividend of $2.2 billion. Following in November 2015, Crystallex filed suit under the Delaware Uniform Fraudulent Transfer Act ("DUFTA") against PDVSA, PDV Holding and CITGO Holding, seeking among other relief the return to the United States of the $2.2 billion that was paid to PDVSA in Venezuela and allegedly to the Republic.

With Crystallex' first lawsuit pending, in October 2016, PDVSA issued bonds as part of an exchange offer secured by 50.1% of PDV Holding's interest in CITGO Holding. This was followed by Crystallex filing a second lawsuit against PDV Holding in the District of Delaware on October 31, 2016. Shortly thereafter, PDV Holding, in a separate financing with Rosneft, pledged the remaining 49.9% of its interest in CITGO Holding, resulting in 100% of the equity interests in CITGO being fully pledged.

From the perspective of Crystallex, the bond issuances and dividends constituted an integrated plan by the Republic to transfer in excess of $2 billion dollars from the United States to Venezuela where the funds could not be available to satisfy a judgment. Defendants' view, however, was that Delaware law imposes liability under the DUFTA only on debtors and not on parties alleged to have participated in an aiding and abetting conspiracy. In this regard, though PDV Holding and CITGO Holding were participants, they were not debtors of Crystallex, or alleged to have been alter egos of PDVSA or the Republic.

The Alter Ego Litigation

In June 2017, Crystallex filed an alter ego proceeding in the District of Delaware seeking to execute its judgment on PDVSA's 100% interest in PDV Holdings arguing that PDVSA was the alter ego of the Republic. The applicable case law[14] required Crystallex to establish that (1) the "corporate entity is so extensively controlled by its owner that a relationship of principal and agent is created," (the "Extensive Control Prong") or (2) treating the corporation as a separate legal entity "would work fraud or injustice" (the "Fraud or Injustice Prong"). Of note, Crystallex filed its argument in a motion for writ of attachment to PDVSA's shares in PDV Holdings rather than seeking a universal declaration, thereby potentially limiting the court's ruling to the facts of its own case and not benefitting other creditors. However, Crystallex also asserted it could establish alter ego based on the evidence it had submitted, all of which was publicly available. So if Crystallex were to prevail, its record might provide the basis for others to establish alter ego and recover from PDVSA.

Crystallex' arguments that Venezuela exercised extensive control over PDVSA included that the Republic ignored PDVSA's separate form, exercised day-to-day control over its operations, used PDVSA property as its own and used PDVSA to implement government programs and policies. On the fraud and injustice front, Crystallex contended that Venezuela gave PDVSA the mineral rights it expropriated by official decree and for no consideration, that PDVSA subsequently sold a 40% interest in the associated land to the government for approximately US $2.4 billion, and that the government designated PDVSA as the "expropriating entity" for the state, conflating numerous other expropriations with PDVSA's involvement.

Responding to Crystallex, PDVSA argued that the court did not have jurisdiction under the Foreign Sovereign Immunities Act of 1976, and even if it did, the shares Crystallex sought to attach were immune as they were not used for a commercial activity. PDVSA also denied

12 Daniel G. Lentz, Lynda H. Schwartz, *"Alter Ego" in Litigation Services Handbook, The Role of the Financial Expert*, ed. Roman L. Weil, Daniel G. Lentz and David P. Hoffman. 23.2 – 5th ed. (Hoboken: John Wiley & Sons, Inc., 2012)

13 Cooper, Richard and Morag, Boaz S., *"Venezuela's Imminent Restructuring and the Role Alter Ego Claims May Play in this Chavismo Saga"* (November 9, 2017). Available at SSRN: https://ssrn.com/abstract=3068455 or http://dx.doi.org/10.2139/ssrn.3068455

14 *First Nat'l City Bank v. Banco Para El Comercio Exterior de Cuba*, 462 U.S. 611, 627, 629 (1983) ("Bancec")

it was the alter ego of Venezuela based on the Bancec presumption that state-owned firms' separateness should be respected, and argued that Crystallex' extensive control allegations indicated PDVSA was no different from a typical government instrumentality. Further, PDVSA argued that the expropriation should not be considered a fraud or injustice with respect to Crystallex, explaining that by the time it was given the mineral rights, years after the expropriation underlying Crystallex' judgement, any harm to Crystallex had been completed.

Summary

The legal distinction between a corporation and its shareholders acts as a "veil" to limit the liability of shareholders to the value of their investment. In circumstances such as those that characterize alter ego, however, the court will pierce the corporate veil to hold the shareholders liable. To establish alter ego, a plaintiff must prove the parent and subsidiary operated as a single economic entity, and that an overall element of injustice or unfairness is present. Doing so requires showing a unity of interest and ownership between the corporation and its owner, and that the outcome would be inequitable if the conduct in question were treated as that of the corporation alone. Financial dependence, confusion as to corporate identity, a lack of separateness and domination and control have emerged in case law as the primary indicia of alter ego. Situations that commonly give rise to piercing based on alter ego include that the parent or subsidiary are judgment-proof, the corporation is judgment-proof but its shareholders are not, confusion over corporate identity due to misrepresentation or failure to observe corporate formalities, or the corporation sold assets to avoid a liability, leaving it undercapitalized. The guidance outlined in § 547 and § 548 of the Bankruptcy Code has proven useful in analyzing these scenarios and seeking recoveries.

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CPA ETHICS

The road to fraud is a slippery slope,
One we would never walk, we hope.
But we should be leery, lest others may say
Our compass appears to be pointed that way.

Our decisions and actions made silently each day
Determine our fate as we stride on our way.
Impressive signs that we post along life's path
Mean nothing to those trampled down in our wrath.

Oh, not me you say, I am a CPA.
I would never handle things that way!
But be careful of the choices you make.
Do they invisibly move your compass each step you take?
And over the course, degree by degree,
Point your ethics in a direction you'd never foresee?

Perhaps it starts out with helping a friend
Who owes lots of taxes, so a small rule you bend.
Or what if your client, a loan covenant has breached?
Minor inventory adjustments shouldn't get one impeached!
Or maybe you're above it all, so you say,
I do fraud accounting, putting bad guys away!

But ethics applies to everyone
With perhaps a higher standard for some.
When determining which job we'll take,
A check for conflicts we always should make,
Using discretion when seeking a case,
Lest it appear we've inappropriately laced.

As you tread down life's road,
Your actions declare your moral code.
Who you are is disclosed by your deeds,
Things you do plant your ethical seeds.
You can claim you have ethics, loud and bold,
Yet, ethics are determined by the kernels you've sown.

Did you say you are honest, but cheat to save on tax?
Did you alter balance sheets to keep covenants intact?
Or did you merely forget to disclose to the clerk
That prior to suing that entity, your office provided work?

Yes, the road to fraud is a slippery slope.
Be wary, lest you slide downward without hope.
Be mindful to check your compass each day,
And never, no never, head down that way!

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