

PIERCING, REVERSE PIERCING (INSIDE AND OUTSIDE)

Curci Investments, LLC v. Baldwin, 14 Cal. App. 5th 214 (4th Dist. August 10, 2017)

Curci Investments, LLC v. Baldwin, 14 Cal. App. 5th 214 (4th Dist. August 10, 2017) (“*Curci Investments*”) held that, in the context of a limited liability company, the creditor of Member may, in appropriate circumstances “reverse pierce” the LLC as a way to obtain assets to satisfy his claim against the Member. In reaching this result, the *Curci Investments* court distinguished an earlier California case, *Postal Instant Press, Inc., v. Kaswa Corp.*, 162 Cal. App. 4th 1510 (4th Dist. 2008)(“*Postal Instant Press*”), which held that, in California, “a third party creditor may not pierce the corporate veil to reach corporate assets to satisfy a shareholder’s personal liability.”

I. Traditional Piercing the Veil of a Corporation.

Piercing the veil of a corporation (or LLC) is alternately referred to as the “alter ego” doctrine. Those of us who went to law school before any human walked on the moon can recall seeing a list of 20 to 25 factors that were examined to see if a corporate shield should be pierced to hold a shareholder responsible for a corporate obligation. Over the years this has evolved to essentially a two-step analysis most recently and comprehensively analyzed in *Sonora Diamond Corp. v. Superior Court*, 83 Cal. App. 4th 523 (5th Dist. 2000). The two steps consist of demonstrating: (1) there is a unity of interest and ownership between the corporation and its owners such that separate personalities of the two do not in reality exist; and (2) an inequitable result would ensue if the wrongful acts (e.g., non-payment of a debt) were treated as acts of the corporation alone. So, generally, courts no longer look to see if meetings are held, officers were appointed, or whether there was at some time adequate capitalization, etc.

2. Reverse Piercing.

Reverse piercing, as the name implies, goes the other way. It is used to show that an asset of the corporation may actually be the asset of a corporate insider (“inside reverse piercing”), or that the assets of the corporation may be reached to satisfy an obligation of a shareholder to the shareholder’s creditor (“outside reverse piercing”). Examination of inside reverse piercing is not within the scope of this article.

Application of the outside reverse piercing doctrine starts with an analysis of the shareholder’s obligation that is being ignored, avoided, dodged, shunned, etc. If that shareholder holds a controlling interest in a corporation, and is using the corporation as his bank account, keeping all of his assets in the corporation and out of the reach of his creditor(s), can the creditor seek to have his judgment against the shareholder expanded to add the corporation as an additional debtor? Code of Civil Procedure Section 187 permits this modification/expansion of the judgment in the case of normal piercing/alter ego. But, as noted above, *Postal Instant Press* held that California law does not recognize reverse piercing.

Postal Instant Press, however, involved a corporation as the entity sought to be held liable on a shareholder's debt. In a corporation, there are four principal reasons why reverse piercing should be discouraged: first, other shareholders' rights would be prejudiced if corporate assets are, in effect, distributed to one shareholder as would happen in reverse piercing; second, other corporate creditors would be prejudiced as the payment to the shareholder's creditor puts that shareholder's equity interest ahead of creditor claims; third, the shareholder's creditor can seek an order having the stock transferred to the creditor whereby the creditor obtains 100% of the interest of the shareholder in the corporation, most importantly including voting rights; and, fourth, legal remedies, such as conversion, fraudulent conveyance (now voidable transfer), aiding and abetting, etc., are available to remedy all but the most unusual abuses of the corporation.

In the LLC context, that third factor is just not available. A creditor who obtains the LLC Member's interest via foreclosure of a charging order lien is merely a Transferee of a Transferable Interest, not a full Member. The creditor may be able to get a charging order against the LLC, but that only allows the creditor to be paid any Distributions that would be payable to the Member. The first, second and fourth factors, however, do militate against reverse piercing in the LLC situation as much as they would in the corporate context.

In the *Curci Investments* case, Curci had been chasing Baldwin for several years on a judgment for \$7.2 million. But Baldwin had all his money and assets in an LLC called JPB Investments, LLC ("JPBI"). The owners of JPBI were Baldwin (99%) and his wife (1%). Baldwin was the sole manager. In the several years before the judgment against Baldwin had been entered, JPBI had distributed at least \$178 million to Baldwin and his wife, but not a single cent had been distributed after the date of the judgment. Meanwhile, some \$42.6 million of debts owed by various Baldwin family members to JPBI came due, but Baldwin extended the due dates of those notes with no consideration being paid for the extensions. The Court held that Baldwin was simply using the LLC as his personal bank account, the creditor did not have an effective remedy to reach JPBI's assets by getting a charging order, or even foreclosing on the Baldwin interests in the LLC, and the *Postal Instant Press* case should not be viewed as binding in the case of a reverse piercing where the entity is an LLC and not a corporation. Recall that in a reverse piercing situation, the entity becomes a joint judgment debtor; as a result, the creditor has a direct claim against the LLC and can, therefore, reach its assets directly. The *Curci Investments* opinion specifically rejected the notion that the LLC Member's creditor was bound by the LLC Act's mandate that the exclusive remedy of a creditor claim against a Member is a charging order, citing Corporations Code Section 17705.03. The opinion notes that the statute provides that the charging order is the exclusive remedy available to a creditor to "satisfy the judgment from the judgment debtor's transferable interest." (Emphasis in original.) Then the opinion continues: "Reverse piercing is a means of reaching the LLC's assets, not the debtor's transferable interest in the LLC" and goes on to note that the Commentary to Section 503 of the Revised Uniform Limited Liability Company Act ("RULLCA") states that the charging order provisions are "not intended to prevent a court from effecting a 'reverse pierce' where appropriate."

3. What About the Internal Affairs Doctrine?

The *Curci Investments* opinion has eleven citations to California Corporations Code sections included in California RULLCA, as well as the reference to the RULLCA Commentary noted above. But at the beginning of the statement of “Facts and Procedural History”, the opinion notes: “Baldwin formed JPBI, a Delaware limited liability company” (*Curci Investments* at page 849). That is the only reference to Delaware in the entire opinion. However, with that one reference to Delaware, it seems appropriate to look at and compare the relevant sections of the California and Delaware LLC Acts.

California Corporations Code Section 17705.03:

(a) On application by a judgment creditor of a member or transferee, a court may enter a charging order against the transferable interest of the judgment debtor for the unsatisfied amount of the judgment.

(b) To the extent necessary to effectuate the collection of distributions pursuant to a charging order in effect under subdivision (a), the court may do any of the following:

(1)

(2)

(3) Upon a showing that distributions under a charging order will not pay the judgment debt within a reasonable time, foreclose the lien and order the sale of the transferable interest. The purchaser at the foreclosure sale obtains only the transferable interest, does not thereby become a member, and is subject to section 17705.02.

(c)

(d)

(e)

(f) This section provides the exclusive remedy by which a person seeking to enforce a judgment against a member or transferee may, in the capacity of judgment creditor, satisfy the judgment from the judgment debtor’s transferable interest.

Delaware Limited Liability Company Act Section 18-703:

(a) On application by a judgment creditor of a member or of a member’s assignee, a court having jurisdiction may charge the limited liability company interest of the judgment debtor to satisfy the judgment.

(b)

(c)

(d) The entry of a charging order is the exclusive remedy by which a judgment creditor of a member or a member’s assignee may satisfy a judgment out of the judgment debtor’s limited liability company interest and attachment, garnishment, foreclosure or other legal or equitable remedies are not available to the judgment creditor, whether the limited liability company has 1 member or more than 1 member.

(e) No creditor of a member or of a member's assignee shall have any right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the limited liability company.

(f)

So, where does this leave us with respect to which law should apply? With respect to limited liability companies, California addresses the internal affairs doctrine in Section 17708.01(a) in a somewhat circular statement:

“(a) The law of the state or other jurisdiction under which a foreign limited liability company is formed governs all of the following:

(1) The organization of the limited liability company, its internal affairs, and the authority of its members and managers.

(2) The liability of a member as member and a manager as manager for the debts, obligations, or other liabilities of the limited liability company.

(b)

(c)

The circularity is the reference in (a)(1) to “the internal affairs”. The U.S. Supreme Court provided a good statement of the internal affairs doctrine in *Edgar v. MITE Corp.*, 457 U.S. 624 (1982) at page 645: “the internal affairs doctrine is a conflict of laws principle which recognizes that one State should have authority to regulate a corporation’s internal affairs---matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders---because otherwise a corporation could be faced with conflicting demands.”

The charging order is often described as being based upon the “pick your partner” rule. Thus, a creditor of a partner could not take over the interest of the partner in satisfaction of his claim against the partner, and thereby become a partner in the partnership against the will of the other partners. As such, the essence of the charging order procedure is to ensure that the other partners cannot be forced to have a partner they did not voluntarily choose. And the natural result of that underlying principle is that the charging order procedure deals with one of the most fundamental internal matters of any entity---who are my partners?

A countervailing argument could be founded on the principle that matters concerning an entity’s obligations to its creditors are not internal matters and should be governed by the law of the entity’s principal place of business, or where the debtor-creditor relationship was established. However, the important word in that sentence is “its”; i.e., the external law governs the rights of a creditor of the entity. But a charging order does not deal with the rights of an entity creditor, and certainly reverse piercing does not deal with the rights of an entity creditor unless and until the judgment against a member is expanded to be a judgment against the entity as well. But that latter can only happen in the case of a Delaware entity if one ignores the provisions in Section 18-703(e) by which a creditor of a member is prohibited from exercising any legal or equitable remedy with respect to the property of the limited liability company.

It should be noted that the *Curci Investments* opinion only directed the matter back to the trial court to determine whether, under its particular set of facts, reverse piercing is

appropriate. Nevertheless, unless *Curci Investments* is overturned by another appellate court or the California Supreme Court, it establishes the law in California that reverse piercing “in an appropriate case” may be pursued where the debt at issue is that of a Member in a limited liability company. It further stands for the proposition that the issue of reverse piercing in the context of a limited liability company is not a matter subject to the internal affairs doctrine whereby the Court will look to the law of the state of formation to determine whether it is permissible.