


# Turning the sow's ear into the silk purse – finding gold in the empty judgment

## *Old cases become a flashpoint when money lands at the debtor's doorstep*

**By David J. Cook**

Default judgments proliferate today in commercial cases and even more tragic, high-end personal-injury cases in which the corporate shell lacks insurance, and the corporate principals might not bear direct liability in perpetration of the tort itself.

Plaintiff's counsel confront claims against corporations or limited liability companies that bear earmarks of a shell or sham and suggest alter ego relief against the corporate principals. Such evidence is found by the following facts:

- Corporation formed at or before the time the debt was incurred.
- Corporate principals are the owners of the preceding sole proprietorship or business.
- Corporation lacks any signs of normal viability (i.e. working telephone number).
- Corporation is suspended for failing to pay franchise taxes.
- The corporation lacks capital, asset, separate physical presence, phone number, or even books and records.

This list is endless. *Associated Vendors, Inc., v. Oakland Meat Co.*, (1962) 210 Cal.App.2d 825 [26 Cal.Rptr. 806 (App. 1 Dist.)] still has the best catalog of indicia of alter ego fact patterns (even to this date). This case contains the premier inventory of indices proving up an alter ego case. Even in the digital age, this case is the touchstone.

The plaintiff faces the challenge of filing suit against the corporate shell and the individual. Is this a viable strategy? Maybe or maybe not. Maybe because plaintiff has only one lawsuit to contend with, one set of lawyers and one trial. If plaintiff has a readily meritorious and provable claim, suing both at the same time is the way to go. What if the claim is just mediocre for a whole host of reasons? Sue the corporation first and the principal second? The default against the corporation is nearly pre-ordained.

### Timeliness

This short note explores the parameters of this strategy, including, the key issue: timeliness.

What happens if the statute of limitations on the underlying claim has expired? Presume in this hypothetical that plaintiff obtained a valid judgment against a shell corporation and did not include in the initial action the "alter ego" (the corporation's principal in the original pleading). Post-judgment, the creditor ascertains that the corporation is a shell or sham. The creditor files a second lawsuit against the corporate principal based on the original claim but predicated upon alter ego liability. The alter ego complains that the underlying statute has run and, moreover, that the alter ego declined to defend because the corporation had no assets. From the alter ego's perspective, defending the lawsuit against the shell would be a waste of time given the fact that the shell was judgment-proof. The alter ego perceived victory in "leading the creditor by the nose" to a judgment against a worthless entity.

*Is this correct? Whose nose is going to get bent?*

Answer: the corporate insider is. To recycle this discussion, alter ego relief is not a cause of action but a form of derivative liability imposed upon a party predicated upon a viable cause of action. Consider alter ego the first cousin to vicarious liability, *respondeat superior*, partnership, joint venture, or conspiracy, in which all of these constitute theories of liability of parties for acts of another.

California case law will permit a creditor to file suit against the alter ego principal based upon the judgment even though the underlying statute of limitations has expired. This means that the judgment creditor can file the second action against the alter ego party even if the underlying statute of limitations on the claim expired. This is not to say that a judgment-creditor can sit and do nothing, as alter ego relief is equitable in nature and potentially subject to an entire array of equitable defenses, including *laches*, estoppel, unclean hands, and waiver.

The classic case is that a claim is, for example, three and a half years and eleven months old and suit is filed against the corporate shell. Plaintiff scores a default judgment in 31 days. The statute has now run on the underlying claim. On day 32, the judgment debtor writes a letter admitting that it is a shell. On day 33, the creditor files a second lawsuit. *Laches* seeking this equitable relief is not the issue.

California cases have explored this issue up to and through the writing of


this article. Given the seminal nature of this analysis, these cases are worth a more detailed analysis.

## A more detailed analysis

• ***Hennessey's Tavern, Inc. v. American Air Filter Co., Inc.*** (1988) 204 Cal.App.3d 1351 [251 Cal.Rptr.2d 859] remains the lead case on the statute of limitations for alter ego liability. The court held that an action may be brought against an alter ego defendant after the statute of limitations on the underlying claim has expired. (*Id.* at 1359.) The court held that an alter ego defendant has no separate primary liability to the plaintiff but is identical to that of the already-named defendant. (*Id*. at 1358.) The claim against the alter ego is not a substantive claim but is only procedural – to disregard the corporate entity to hold the alter ego liable for the obligations of the principal. Hennessy's also outlines the options in seeking affix alter ego liability, including post trial motions [*Dow Jones, Inc. v. Avenel* (1984) 151 Cal.App.3d 144, only if the case tried. (See *Motores De Mexicali v. Superior Court* (1958) 51 Cal.2d 172, 174-176 [barring post judgment motion practice to add an alter ego] or a new action. (*Taylor v. Newton* (1953) 117 Cal.App.2d 752, 753-757).]

• ***Greenspan v. LADT, LLC*** (2010) 191 Cal.App.4th 486 [121 Cal.Rptr.3d 118) is the most recent application of *Hennessey's*. In *Greenspan*, the court explained why the statute of limitations may not bar liability against the alter ego. The court held that if the creditor could show that the debtor's principal had dominance over the shell (it) would establish "virtual representation" of the principal. (*Id*. at 509.) The court went on to hold that the alter ego determination is unrelated to liability determinations on the underlying claims and is "simply a means of satisfying a judgment against individuals and companies that have ignored each other's separate existence in conducting business, thereby creating a single enterprise." (*Id.* at 516-517.) The 9th Circuit applied alter ego theory in affixing liability upon individual trustees of the trust in *In Re Schwarzkopf* 626 F.3rd. 1032, 1037-1039 (9th Circuit, 2010). This case upheld an alter ego finding based upon the individual's equitable ownership.

*What does this mean to the civil practitioner?* Assuming that the first judgment is valid on its face, free of jurisdictional defects, and immune from any discretionary relief to set it aside, the sole issue in a second action is the alter ego liability. This outcome provides a unique and somewhat precarious strategy. If the plaintiff's claim is weak, defensible, or supported by only mediocre proof of damages, or blemished in the civil litigation, plaintiff may choose to sue, serve, and obtain judgment on the weak claim against the corporate shell. Needless to say, a default is likely because the underlying principal formed the shell to channel litigation away from the individual and toward the sham corporation.

Assuming the judgment remains intact or invulnerable to post-judgment relief, the plaintiff may file a second lawsuit against the corporate insiders whose sole defense is the alter ego relief, as opposed to a defense on the merits against the underlying claim. Is this a winning strategy in the prosecution of weak claims? The cases say so. But don't leave home without reading these cases.

## Rules of the road

How vulnerable is that judgment to discretionary relief? The answer is what the plaintiff is doing to enforce the judgment. We are talking about large dollar judgments that would make an impact in anyone's net worth. Here are the basic rules of the road for when a creditor seeks to enforce a large dollar judgment:

• *Discretionary relief under C.C.P. § 473* [Fed. R. Civ P. 60(b) (4)] – This section relieves a party from a judgment based upon excusable neglect, inadvertence, and surprise. The case law explaining this section would readily overflow an entire library wall (assuming that libraries still house print volumes). Suffice it to say, judges are inclined to vacate large dollar default judgments if the motion is timely filed and the defendant has a rational excuse. Case law on this favors the defendant. Therefore, given the dire consequences evolving from the strategy, the clever defense counsel would attack the underlying judgment if relief is still available.

• *Discretionary relief in the absence of notice of the action under C.C.P. § 473.5* – The short summary of this section is that the defendant can vacate the judgment claiming ignorance of the action. These motions arise from substituted service, in which service is typically upon a member of the household, or coworker or employer in a place of business. This is precisely the formula for a defendant to deny actual notice, thus entitling the defendant to this relief.

• *Extrinsic fraud* [Fed. R. Civ. P. 60(b)(4)&(6)] – this is a catchall for some type of intervening event or conduct that prevented the defendant from access to the court. This covers the entire gamut of conduct ranging from misstatements from adverse counsel to third parties intercepting process or virtually any other act or omission which cheated defendant out of access to the court. The leading case is *Stiles v. Wallis*, (1983) 147 Cal.App.3d 1143 [195 Cal.Rptr. 377 (App. 2 Dist.)], with everything following suit from that. While the civil practitioner would be hard-pressed to engage in archaeology to review the file, nonetheless, the file must be perfect and the defendant will exploit any defect that could support extrinsic relief. Extrinsic relief is an equitable relief and subject to equitable defenses. (See *Lee vs. An*, [2008] 168 Cal.App.4th 558, 566 [App. 2 Dist.]) To overcome any claim of extrinsic fraud compels the judgment creditor to clearly communicate the existence of the judgment and how service was effectuated. Odd as it may sound, extrinsic fraud cases founder for lack of timeliness.


• *Void judgments* – This is very painful. *Greenup v. Rodman*, (1986) 42 Cal.3d 822 [231 Cal.Rptr. 220] [the horse manure case], offers a perfect example of a void judgment. The file lacks proof of service of the statement of damages. The proof of service for the summons and complaint is faulty on its face (e.g., the summons was not properly endorsed). *Is all for naught?* No. California law permits a plaintiff three years to effectuate service. (***Hennessey,*** *supra.)* If the three years has not run and the judgment is void and not voidable, the plaintiff has the option to vacate the judgment and re-serve the defendant (see ***Hennessey*** at 1360). This also potentially applies to Doe defendants, assuming that the dismissal of the Does is vacated.

If the plaintiffs are minors (i.e., under 18) or suffer from some other statutory disability, the statute has not run. For example, the minor can file upon injury or upon reaching age of majority. Assuming the judgment is irreparably void but the claim is still viable, nothing stops the plaintiff from vacating the judgment, dismissing the action without prejudice, and starting over. Don't do this until you have read, reviewed, and examined the case law and memorized the contents of your file. Before filing suit against the insider, assume that counsel will explore whether the underlying judgment is vulnerable to attack and sidetrack the ancillary relief.

Enforcement of judgments focuses everybody's attention upon the validity of the judgment like a particle in a superconductor supercollider. Just to make my point clear, I was waiting in line at the Clerk's Office. A lawyer was ahead of me. He was reviewing a file, page by page, at the Clerk's window. He was turning over each page very slowly and very carefully while taking notes in small print. I looked over his shoulder and saw that it was one of our files. Total and complete shocker? No. This is the normal course of business. By the way, we won the motion.

Just to ensure that the reader appreciates the gravity of these issues, we were confronted with a motion brought by the debtor to vacate the judgment nine and a half years after its entry. The debtor claimed bad service and attached a proof of service to his moving papers. Our file was in cold storage and had been untouched for many years. The file smelled of must. We popped open the file and found that our proof of service differed from the defendant's. The key difference was the place of service – which proved to be dispositive. At the hearing on the motion to vacate, the judge ordered a full-blown trial consisting of the defendant and the process server. The process server swore that the proof was accurate, as represented by our nine-and-a-half-year-old document. The judge compared the defendant's proof to the proof in the file. After reviewing the file for about two minutes, the judge looked at me and then looked at the defendant. There was dead silence. Money was in hand because the debtor won a major class-action lawsuit. Either we would be paid or I had a malpractice lawsuit on my hands. After a few seconds, the judge said, "Denied."

Old cases become a flashpoint when money lands at the debtor's doorstep. In one case, 14 years after the judgment, the debtor denied service of process and even that he was involved in the proceeding. The file was recreated from numerous sources showing that the defendant had been served, had filed an answer, and even a cross-complaint. When money is at hand, wonders never cease.

What does the article teach you? Enforcement of default judgments, whether against the debtor's assets or third-party ancillary actions, is a very precarious, dangerous, and an unforgiving venture.


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