RULE B AND THE ALTER EGO – HAVE THE COURTS PIERCED THE CORPORATE VEIL?

By Lawrence Rutkowski and Bruce Paulsen

INTRODUCTION

Rule B attachment – the pre-judgment seizure of assets in maritime cases -- has been a hot topic for several years now. Rule B cases have, in some areas, substantially altered the traditional application of otherwise well-settled principles of law. For instance, though ostensibly two sides of the same coin, alter ego analysis under Rule B appears to have become divergent from, and more lax than, the established standards of "piercing the corporate veil" in corporate law. In many ways, it is now easier for a maritime claimant to pierce the corporate veil – and attach the assets of alleged "alter egos" – than it is under general jurisprudence. This development has wide-ranging practical ramifications. (As discussed in this article and as used in court decisions, an "alter ego" is an affiliated company whose identity is virtually indistinguishable from the defendant who allegedly committed the tort or breached the contract at issue; courts often refer to the principal defendant as a "mere instrumentality" of the alter ego.)

A SHORT PRIMER ON RULE B

Historically, Rule B owes its existence to the transitory nature of assets within the maritime industry. Vessels travel from port to port and may vanish from the view and reach of their owner's or charterer's creditors; other assets may be reachable only in distant and inaccessible jurisdictions or hidden behind dense corporate structures, perhaps leaving creditors without security on unpaid maritime contracts. Rule B provides for an extraordinary remedy to maritime creditors. It permits pre-trial, *ex parte* attachment of assets; the significance of this being that the debtor need not be aware of the complaint before its assets are seized. In addition, a plaintiff is not required to post security to initiate a Rule B action, which limits the transaction costs and risks associated with bringing a legal claim against a defendant. In order to permit the attachment and/or garnishment of property of a debtor the court must determine, (i) whether the plaintiff has a valid *prima facie* admiralty claim; (ii) whether the defendant cannot be found within the district; (iii) Whether the defendant's property can be found within the district and (iv) that there are no maritime or statutory bars to attachment.[1]

Historically, there have been two recognized purposes for Rule B: (1) to compel the defendant's appearance in the maritime action; and (2) to provide security for the plaintiff's underlying claim.[2] Attachment can be used to obtain security for maritime claims being litigated or arbitrated elsewhere, including outside the United States and, indeed, Rule B is currently used most frequently to provide security for litigations and arbitrations in foreign jurisdictions.

Before, during, or even after a proceeding on the underlying claim, Rule B can be used to freeze the assets of a company or its "alter egos". In recent years, it has mostly been utilized to attach electronic funds transfers, which in 2002 were determined to be attachable "property" under maritime law.[3] Any wire transfer made in U.S. dollars passes through a clearing house system, constituted primarily of a number of intermediary money center banks located in the New York City. As a consequence, New York City has become the center of modern day Rule B litigation and case law.

ALTER EGO ANALYSIS

In jurisprudence, so-called alter egos are entities which engage in business under separate names, but legally have no distinction in corporate form, because of either a combination of shared officers and directors, office space, assets and liabilities, undocumented intercompany loans and so forth, or when one company so domi-

nates another such that the two are indistinguishable. In the non-Rule B context, typically the question is whether the claimant can "pierce the corporate veil" to reach beyond the principal defendant to its shareholder or affiliates. Presumably, in Rule B the analysis of an alter ego claim should be the same. But has it been?

The law in the United States has consistently recognized the corporate form as a shield against liability. In only the rarest of circumstances are shareholders or affiliates held accountable for the liabilities of the party in privity with a claimant whether the claim is a tort claim or a contract claim. When the questions do arise outside of Rule B they usually arise in the context of a tort claim. This is understandable and there may even be judicial sensitivity to the notion that wronged parties should have recourse beyond a mere coporate shell, but should the same sensitivity apply when the underlying claim is one based in contract as most of the recent Rule B actions have been? Could not the claimant have sought and obtained guarantees from affiliates when negotiating their contracts?

1. Analysis in Favor of Creditors

If a creditor can plead that a company is the alter ego of another, judges have frequently allowed the creditor to attach the alleged alter ego's assets, even in the clear absence of contractual privity with the creditor.[4] When examining the allegations, judges should look to several factors to determine whether an alter ego relationship exists, many of which are fairly intuitive. The following is a list of some of the factors that have been used by the courts:

(1) whether corporate formalities are observed;
(2) whether the capitalization of a subsidiary is adequate;
(3) financing of a subsidiary by a parent
(4) whether funds are put in and taken out of the corporation for personal rather than corporate purposes;
(5) whether there is overlap in ownership, officers, directors, and personnel;
(6) whether the corporate entities share common office space, address and telephone numbers;
(7) the amount of business discretion displayed by the allegedly dominated corporation;
(8) whether the alleged dominator deals with the dominated corporation at arms length;
(9) whether the corporation is treated as an inde-

pendent profit center;

(10) whether others pay or guarantee debts of the dominated corporation;

(11) whether the corporation in question had property that was used by the alleged dominator as if it were the dominator's own;

(12) whether the parent exists solely as a holding company of subsidiaries;

(13) whether the companies file consolidated income tax returns; and

(14) the existence of fraud, wrongdoing, or injustice to third parties;

William Passalaqua Builders, et al. v. Resnick Developers South, Inc. et. al.;[5] *Northern Tankers (Cyprus) Ltd. v. Adam Backstrom.*[6]

As a general proposition, piercing the corporate veil is a cumbersome feat for plaintiffs and it is axiomatic that it is both expensive and rarely likely to succeed. However, the *ex parte*, pre-judgment nature of Rule B attachment orders provides judges with little ground on which to challenge alter ego allegations made in a Rule B complaint. Moreover, the underlying trial on the merits, frequently a foreign arbitration proceeding, often has not even been commenced before the judge grants the Rule B order. Therefore, recent attachment orders have included alter ego allegations that would unlikely withstand full scrutiny. Correspondingly, vacating a Rule B attachment based on alter ego allegations is often difficult in practice because judges are reluctant to touch on the merits of alter ego allegations, no matter how sparsely pled in the attachment papers. Ruling on a motion to vacate, a judge generally limits himself or herself to looking "within the four corners" of the complaint and accepts the allegations as true, and leaves the merits to be decided by the foreign court or arbitration panel.

The seminal Rule B case, *Aqua Stoli Shipping Ltd. v. Garnder Smith Pty Ltd.*,[7] solidified the standard of review. As explained in *Tide Line v. Eastrade Commodities*, some courts previously held that "a hearing [on the validity of an attachment] is intended to 'make a preliminary determination whether there were **reasonable grounds** for issuing the warrant.'"[8] The "reasonable grounds" standard would require a plaintiff to present evidence to justify the maintenance of a Rule B attachment if said attachment is challenged by a defendant. the *Aqua Stoli* Court changed the "reasonable grounds" standard. The *Tide Line* court held, "*Aqua Stoli* implies "that the 'probable

cause' or 'reasonable grounds' standard is generally improper when considering whether a maritime attachment must be vacated.[9] The court found that it need not engage in a broad inquiry into evidence but rather only a narrow inquiry into whether the claimant has shown that it has a valid *prima facie* claim against the defendant on the basis of alleged alter ego status. This construction is highly pro-claimant.

Cases subsequent to *Tide Line*, however, have somewhat modified the analysis. There is now support for the position that a "district court does not abuse its discretion when it considers evidence outside of the pleadings on motion to vacate an order."[10] For example, the court in both the cases of *Bell Atlantic v. Twombly*[11] and *Iqbal v. Hasty*[12] have both required a plaintiff to amplify its allegations with factual assertions that render the claim plausible. However, some judges have only required minimal allegation to meet the factual threshold such as the related companies sharing common contact information, use of company names interchangeably in advertising materials or a reputation within the maritime industry as a paper company.[13] When the courts apply these minimal standards, that is, when a more complete corporate veil piercing analysis is not conducted at the attachment phase, havoc may ensue for the principal defendant's alleged alter egos who may have substantial funds tied up for long periods of time on the most cursory of allegations.

2. Analysis in Favor of Debtors

Yet, the lax alter ego standard used by district courts in Rule B cases can also work to assist a complexly structured network of shipping companies. *Transfield ER Cape Ltd. v. Industrial Carriers, Inc.*[14] follows from the decision in *STX Panocean (UK) Co., Ltd. v. Glory Wealth Shipping Pte Ltd. et al,*[15] where the Second Circuit ruled that a company that registers to do business in New York State and appoints an agent for service of process in New York City is "found" in the district for purposes of Rule B. Therefore, a method of avoiding Rule B liability is to register to do business in the judicial district in which the Rule B order of attachment is sought.[16] The *Transfield* court went further, however, to issue a clear edict that the alter ego of a corporation that is registered to do business, and therefore "found" within the district for purposes of Rule B, is likewise "found" within the district. Therefore, the alter ego is not subject to the maritime attachment under those circumstances.

So, whereas recent decisions have allowed maritime attachments to stand against alleged alter egos where scant allegations have been made as to an alter ego relationship, now those companies are afforded protection from attachment by the same federal court that exposed them to attachment in the first place. This is a curious twist.

The Second Circuit's ruling is important because it clears the way for entities carrying on business through various alter egos to avoid Rule B for each of them merely by registering one of them.

IV. Conclusion.

The overall construction of the alter ego analysis is of great importance to the maritime industry, since many shipping companies create special purpose entities, each designed to perform special tasks, such as to own or charter a vessel of the "parent" company. In most cases this design is meant to limit the liability of the parent related to each vessel. A court is more ready to pierce the corporate veil in the Rule B context than would occur under normal proceedings, thus creating a nexus of liability between "parent" and "sister" companies of a debtor that would not otherwise exist. An attachment order can successfully tie up a related entity's assets while the alter ego questions are litigated – at the usual pace – in some other jurisdiction. This can give a Rule B plaintiff a substantial leg up in a particular dispute. Whether or not it should is a different question.

The argument can be made that the form in which Rule B is now fashioned provides less incentive for creditors to seek adequate security. There are more effective mechanisms with which to obtain similar security interests. Contracts may be drafted to ensure security for any claims, without added Rule B litigation and uncertainty. A creditor can seek a guaranty from companies that are purported to be related to the debtor or other types of additional security, for example, a pledge in the related company's equity interests, can be sought. The hardship that an attachment order may impose on a prospective debtor may be adequate incentive to provide the necessary safeguards.

The case of T*ransfield ER Cape* seems to help counter some of the highly pro-creditor construction of the alter ego analysis. However, it is interesting to note that the analysis in the case was limited to alter egos and did not address a conventional parent-subsidiary (or affiliate), relationship. A true subsidiary, which is a distinct corporate entity where the requirements of corporate separateness are observed, might not be able to avoid Rule B merely because of the registration of its parent. Thus, a curious result of *Transfield ER Cape* is that valid subsidiaries and affiliates are still subject to attachment when, for example, their parents register to do business in New York, but sham, alter ego corporations are not. If a company or group of compa-

nies wishes to avoid Rule B attachment altogether in a jurisdiction, all potentially exposed entities should be registered in such jurisdiction, and agents for service appointed for each of them.

The pace of developments in the Rule B arena has been rapid in recent years, but with the recent rulings in connection with registration to do business in New York, the number of cases has dropped significantly in the past few months. One hopes that some of the confusion sown in the alter ego cases will get sorted out before the Rule B wave comes to an end.

Larry Rutkowski and Bruce G. Paulsen are partners of Seward & Kissel LLP. Brian Doyle and Jonathan Stoian, associates at the firm, assisted in the preparation of the article.

---

[1] *Aqua Stoli Shipping Ltd v. Gardner Smith, 460 F.3d 434 (2d Cir. 2006).*
[2] *See Winter Storm Shipping, Ltd. v. TPI, 310 F.3d 263, 268 (2d Cir. 2002)*
[3] *See Winter Storm Shipping, Ltd. v. TPI, 310 F.3d 263, 268 (2d Cir. 2002).*
[4] *Wm. Passalacqua Builders, Inc. et al. v. Resnick Developers South, Inc., et. al. 933 F.2d 131, 139 (2d Cir. 1991)*
[5] *933 F.2d 131, 139 (2d Cir. 1990).*
[6] *967 F. Supp. 1391 (D. Conn. 1997).*
[7] *460 F.3d 434 (2d Cir. 2006).*
[8] *2007 AMC 252 (S.D.N.Y. 2007) (emphasis added).*
[9] *See id.*
[10] *See SPL Shipping Ltd. v. Gujarat Chiminex Ltd., 2008 U.S. Dist. LEXIS 95674 (citing to the Second Circuit's decision in Williamson v. Recovery Ltd. P'ship, 542 F.3d 43, (2d Cir. 2008)).*
[11] *550 U.S. 544 (2007).*
[12] *490 F.3d 143 (2d Cir. 2007).*
[13] *See Wilhelmsen Premier Marine Fuels v UBS Provedores Pty. Ltd., 519 F. Supp. 2d 399 (S.D.N.Y. 2007); see also Goodearth Mar. Ltd. V. Calder Seacarrier Corp., 2008 U.S. Dist. LEXIS 56206 (S.D.N.Y. July 21, 2008.*
[14] *571 F.3d 221 (2d Cir. N.Y. 2009).*
[15] *560 F.3d 127 (2d Cir. N.Y. 2009).*
[16] *Please note that such registration must take place before a Rule B attachment is sought against the defendant company.*