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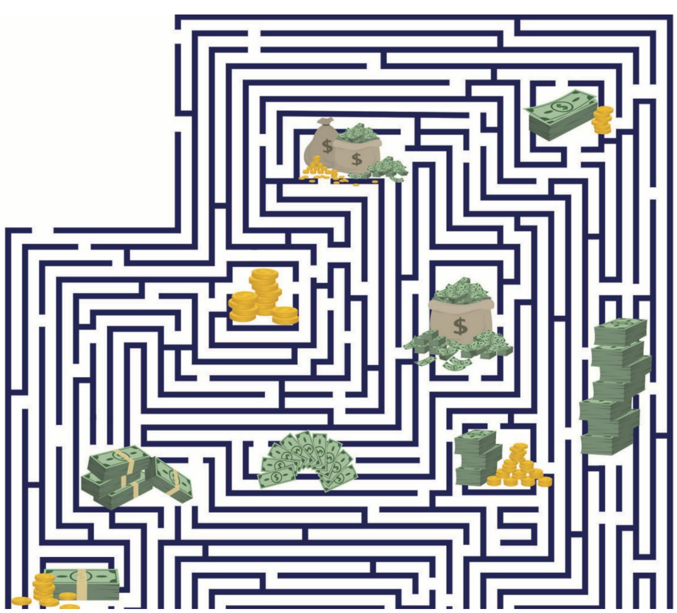
Reverse Veil-Piercing Deployed for Dissenting Shareholders

State court announces equitable doctrine may be applied to prevent judgment debtor from using its subsidiaries to avoid paying appraisal judgment in favor of judgment creditors

By Kelso L. Anderson

Share:

In an issue of first impression, the Delaware Court of Chancery has recognized the equitable doctrine of reverse veil-piercing as a potential remedy in cases in which an acquiring company attempts to use its subsidiaries to avoid paying dissenting shareholders following a merger. The opposite of traditional veil-piercing—which involves creditors reaching up the corporate chain to hold a parent liable for actions of its affiliates or subsidiaries—reverse veil-piercing imposes liability on a business organization for the actions of its owners. ABA Litigation Section leaders opine that the case does not reflect a trend but urge practitioners to be mindful of reverse veil-piercing in a post-merger context.



The defendant created a maze of subsidiaries in oan attempt to hide assets.
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The Parties, the Merger, and Statutory Appraisal

In *Manichean Capital, LLC v. Exela Technologies, Inc.*, the plaintiffs—two corporations, one limited liability company (LLC), and two individuals—were equity shareholders of defendant SourceHOV Holdings. The plaintiffs had dissented to a merger of SourceHOV and its many LLC subsidiaries into the defendant Exela Technologies, through which SourceHOV became a wholly owned subsidiary of Exela.

As dissenting shareholders, the plaintiffs exercised their right to statutory appraisal of the value of their shares in SourceHOV. They obtained a $57 million appraisal judgment—several million more than the defendants had offered the plaintiffs for their shares in the merger. To procure full payment for their shares, the plaintiffs obtained a charging order requiring SourceHOV to pay the judgment before any funds could be transferred to acquirer Exela. But SourceHOV did not have assets. The plaintiffs sought to hold Exela, as acquirer and parent, and its affiliated entities accountable for the appraisal judgment on a theory of outsider reverse veil-piercing based on alleged abuse of corporate form.

Exela's Alleged Disregard of Corporate Form

Mere weeks before the Delaware Court of Chancery issued the appraisal judgment, Exela, acting through its subsidiaries, created two new entities to receive capital distributions from SourceHOV's subsidiaries. Pursuant to a purchase and sale agreement, SourceHOV's subsidiaries sold their accounts receivable to one of the new entities. The second entity would acquire the accounts receivable and pledge them as collateral for loans and letters of credit, absorbing funds that would otherwise flow up to SourceHOV. Exela served as the guarantor for all moneys borrowed under this arrangement and was the servicer on the loan and security agreement.

Shareholder Rights Sacred

The plaintiffs alleged Exela had funneled assets through its subsidiaries to render SourceHOV judgment-proof and urged the court to pierce the corporate veil upward to reach defendant Exela (traditional veil-piercing) and downward to reach defendant SourceHOV's solvent LLC subsidiaries (reverse veil-piercing). The defendants, on the other hand, sought to dismiss the plaintiffs' complaint pursuant to Rule 12(b)(6) of the Delaware Rules of the Court of the Chancery for failure to state a claim because Delaware had hitherto never recognized reverse veil-piercing.

The court began its analysis by discussing the purpose of statutory appraisal under Delaware law. The court noted that at common law, all major corporate decisions required unanimous consent of shareholders, which created the phenomenon called "nuisance blocking"—a veto right exercised by a shareholder to halt any action sanctioned by a corporate board. To address nuisance blocking, Delaware created statutory appraisal rights to compensate dissenting shareholders "for the abrogation of the common law rule that a single shareholder could block a merger." For statutory appraisal to make sense, "shareholders must have a means to secure fair value through a proper appraisal of their shares," the court added.

In appraisal actions in which the sale of a corporation is involved, "it is the acquirer, not the target, who is the real party in interest on the respondent's side of a case," the court observed. It ultimately held that the statutory framework established the availability of reverse veil-piercing in cases where the assets of a judgment-debtor subsidiary may be used to satisfy a judgment in favor of a judgment creditor.

The Argument for Reverse Veil-Piercing

There are two types of reverse veil-piercing, the court explained: insider veil-piercing and outsider veil-piercing. Insider veil-piercing occurs where a controlling LLC member asks a court to disregard the corporate entity that separates the member from the corporation. Outsider veil-piercing is implicated when a third-party creditor urges a court to impose liability on a company for a judgment against its member, the court explained. Since the plaintiffs here sought to impose liability on SourceHOV as the single member and 100 percent owner of its subsidiaries, the court concluded that outsider veil-piercing was at issue.

> “Reverse veil-piercing is an extreme remedy to be reserved for the most egregious and nefarious forms of corporate abuse to creditors, but acknowledges the need for a path for recovery in such circumstances so that bad actors can't get away scot-free

Sean O.D. Bosack, Milwaukee, WI
Cochair, Corporate Counsel Committee

Citing Judge Learned Hand's 1929 opinion in *Kingston Dry Dock Co. v. Lake Champlain Transportation Co.* as the earliest case to discuss the issue of reverse veil-piercing, the court noted that reverse veil-piercing was not authorized in *Kingston Dry Dock* because the subsidiary had not interposed in the conduct of its parent's affairs. Courts rejecting reverse veil-piercing cite concern for innocent creditors and shareholders as the primary reasons. Accepting those concerns, the court here reasoned that "recognition of th[ose] risks creates an opportunity to manage them, and to do so in a manner that serves the interest of equity."

In dicta, the court noted that in *C.F. Trust Inc. v. First Flight L.P.*, the Virginia Supreme Court embraced reverse veil-piercing on the principle that it sought to protect the same wrongdoings as traditional veil-piercing: abuse of corporate form and fraud. Similarly, in *In re Phillips*, the Colorado Supreme Court reasoned that outside veil-piercing must be authorized only where innocent shareholders and creditors are not harmed. Amplifying the factors courts examine to determine if traditional veil-piercing should apply, the court here adopted outsider veil-piercing as applicable in cases in which no other legal remedy exists except to reach the assets of the judgment debtor or its parent to satisfy a judgment in favor of a creditor.

The court announced an eight-factor test, which includes the five factors involved in traditional veil-piercing, to determine the propriety of reverse veil-piercing to a particular case. None of the eight factors are dispositive, and the court must ensure innocent shareholders or other creditors are not harmed by the decision to allow reverse veil-piercing to satisfy a judgment. Some key factors include disregard of corporate form, extent and severity of wrongful conduct, and the extent to which reverse veil-piercing will harm third-party creditors of the entity the plaintiff seeks to pierce.

Narrow and Untrendy Remedy

Litigation Section leaders agree that reverse veil-piercing has narrow application but remind corporate litigators to be mindful of the concept when reviewing target companies for mergers and acquisitions. "I do not think the *Manichean* decision reflects a trend or is likely to result in a trend," hazards Sean O.D. Bosack, Milwaukee, WI, cochair of the Section's Corporate Counsel Committee. "I think the decision struck an appropriate balance between making it clear that reverse veil-piercing is an extreme remedy to be reserved for the most egregious and nefarious instances of the use of corporate form to abuse creditors, while at the same time acknowledging that there needs to be a path for recovery in such circumstances so that bad actors can't count on getting away scot-free simply by invoking protections associated with corporate form."

Likewise, when conducting due diligence of a target company, practitioners must be aware of the availability of reverse veil-piercing when they evaluate potential liabilities, cautions Cason M. Kirby, Birmingham, AL, cochair of the Section's Fraud Subcommittee of the Business Torts & Unfair Competition Committee. In particular, Kirby opines that, "in the mergers and acquisitions context, this decision highlights the necessity of both identifying and valuating potential legal liabilities in the due diligence process. The structuring of a new or successor entity can and should isolate potential liabilities that could implicate reverse veil-piercing."

Resources

- Del. R. Court of Chancery 12: Defenses and objections.
- *Manichean Capital, LLC v. Exela Tech. Inc.*, C.A. No. 2020-0601-JRS (Del. Ch. May 25, 2021).
- *Acree v. McMahan*, 585 S.E.2d 873 (Ga. 2003)
- *Postal Instant Press, Inc. v. Kaswa Corp.*, 77 Cal. Rptr. 3d 96 (Ca. App.

4th 2008)

- *Sky Cable, LLC v. DirectTV, Inc.*, 886 F.3d 375 (4th Cir. 2018)
- Elizabeth S. Fenton, "Trends in Piercing the Corporate Veil," *Business Torts & Unfair Competition* (July 31, 2013).
- *Kingston Dry Dock Co. v. Lake Champlain Transportation Co.*, 31 F.2d 265 (2d Cir. 1929).
- *C.F. Trust Inc. v. First Flight L.P.*, No. 022212 (4th Cir. June 6, 2003).
- *In re Phillips*, 139 P.3d 639 (Sup. Ct. Col 2006).

Authors

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