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Manichean struggle: Reverse veil-piercing authorized in Delaware

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A recent decision from the Delaware Chancery Court has established, for the first time, that the remedy of reverse veil-piercing is recognized under Delaware law.

The decision, *Manichean Capital, LLC v. Exela Technologies, Inc.*, resolves a dispute regarding the availability of reverse veil-piercing and augments the remedies for minority shareholders dissenting from a merger.

Background

Manichean arose from a 2017 merger. Exela Technologies acquired SourceHOV, a business services provider incorporated in Delaware. Certain minority shareholders of SourceHOV expressly dissented with respect to the merger and brought an appraisal action.

The opinion states that reverse veil-piercing will be permitted only in exceptional cases, and that the requirement that innocent third parties not be prejudiced will, as a practical matter, substantially limit the doctrine's application.

The Chancery Court largely sided with the plaintiffs' appraisers and, in March 2020, entered judgment for $57.6 million against SourceHOV Holdings, a Delaware limited liability corporation ("LLC") that was the surviving entity of the merger.

In August 2020, the plaintiffs obtained a "charging order" to enforce the judgment. Under Delaware law, a charging order provides for a judgment creditor to receive a lien on LLC distributions owed to a judgment debtor/member and is the sole remedy for judgment creditors with respect to LLC membership assets of a judgment debtor.

In February 2021, the former shareholders/judgment creditors brought a new action seeking veil-piercing and reverse veil-piercing to enforce the charging order, which, they alleged, Exela and its subsidiaries had schemed to subvert.

Specifically, weeks before the court handed down its decision in the appraisal action, certain subsidiaries of Exela had entered into an accounts receivable securitization facility. Under the facility, subsidiaries of SourceHOV Holdings sold their receivables to newly formed subsidiaries of Exela.

The former shareholders/judgment creditors alleged that the purpose of the accounts receivable securitization facility was to frustrate the charging order by creating an alternative route for Exela to realize value from the SourceHOV Holdings subsidiaries.

Under the subsequently obtained charging order, subsidiary profits that were upstreamed through SourceHOV Holdings would have been subject to the charging order lien; under the accounts receivable securitization facility those funds did not pass through SourceHOV Holdings.

The defendants filed a motion to dismiss, arguing that (1) equitable remedies such as reverse veil-piercing are barred by the provision of Delaware law that a charging order is the sole remedy for judgment creditors with respect to LLC assets, and (2) reverse veil-piercing is an equitable remedy that is not recognized under Delaware law.

Reverse veil-piercing

Reverse veil-piercing is a variant of traditional veil-piercing, in which a creditor of a corporate entity can disregard corporate separateness and "pierce the corporate veil" by obtaining a recovery from a corporate parent. In reverse veil-piercing, a creditor of a corporate entity seeks to obtain recovery from subsidiaries of a corporate debtor.

The decision

The Chancery Court ruled in favor of the former shareholders/judgment creditors. It reasoned that enforcement or clarification of a charging order by veil-piercing and reverse veil-piercing is not barred by the statute.

It further determined that reverse veil-piercing can be awarded under Delaware law to remedy fraud and injustice in limited circumstances. It promulgated a list of eight factors for courts to consider in determining whether reverse veil-piercing is appropriate, including whether reverse veil-piercing would negatively affect creditors of the subsidiary or other innocent third parties.

Analysis

The defendants argued that the accounts receivable securitization facility had a business justification and would not have the effect of frustrating the charging order. Because the Manichean decision was in response to a motion to dismiss, the court assumed, for the purposes of the decision, that the plaintiffs' factual allegations were true.

Based solely on the facts alleged in the complaint, the court noted that reverse veil-piercing in this circumstance would not harm innocent shareholders or creditors. The defendants will have an opportunity to challenge these alleged facts in further proceedings.

The Delaware charging order statute is considered to be a corporate-friendly provision meant to encourage businesses to choose Delaware as the state of incorporation for LLCs. Some commentators have argued that charging orders operate more as a limitation on a plaintiff's remedies than as a tool to assist recovery for plaintiffs.

Indeed, the plaintiffs' central allegation was that Exela used its control of SourceHOV Holdings and other subsidiaries to structure around the charging order in a way that, if upheld, could be a template for other judgment debtors. The Manichean decision may help define the extent to which charging orders are useful for plaintiffs.

The opinion states that reverse veil-piercing will be permitted only in exceptional cases, and that the requirement that innocent third parties not be prejudiced will, as a practical matter, substantially limit the doctrine's application. One can expect that creative plaintiffs' lawyers will test the applicability the doctrine in other areas.

About the authors

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