

# Delaware Court of Chancery Endorses Reverse Veil-Piercing

## Delaware Law Update

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### Related People:

Philip D. Amoa  
Travis J. Ferguson  
Matthew J. Rifino

The Delaware Court of Chancery has recognized, for the first time, that the equitable remedy of reverse veil-piercing is available under Delaware law. The court's decision in *Manichaeen Capital, LLC v. Exela Technologies Inc., et al.*, 251 A.3d 694 (Del. Ch. May 25, 2021) (Slights, V.C.), endorsed the availability of "outsider" reverse veil-piercing as a remedy for third-party creditors seeking to recover assets on a judgment against a parent that may be stored in a complex corporate structure. Reverse veil-piercing involves the imposition of liability on an entity for the liability of its owners.

In a matter of first impression, the court ruled that reverse veil-piercing is available under Delaware law in limited circumstances and circumscribed fashion and that charging orders under Delaware's LLC statute do not bar an equitable reverse veil-piercing claim. The court endorsed only "outsider" reverse veil-piercing where "an outside third party, frequently a creditor, urges a court to render a company liable on a judgment against its member." The court ruled that the same factors that Delaware courts consider when reviewing a traditional veil-piercing claim are the starting place for a reverse veil-piercing claim (e.g., insolvency, undercapitalization, commingling of funds, absence of corporate formalities, and whether the subsidiary is simply a façade for the owner). But where the court considers whether the owner in a reverse veil-piercing situation is utilizing the corporate form to perpetuate a fraud or injustice, the court outlined eight additional factors for consideration. The focus of these additional considerations is to weigh the legitimate and varying concerns of innocent third-party creditors and investors.

The underlying dispute in *Manichaeen* arose from the 2017 merger of SourceHov Holdings, Inc. (SourceHOV), into a subsidiary of Exela Technologies, Inc. (Exela). The plaintiffs in this case, who are former stockholders of SourceHOV, dissented to that merger and pursued their statutory appraisal rights. In the appraisal action, the plaintiffs won and obtained a judgement of \$57,684,471 plus interest, which was significantly more than the consideration they would have received in the merger.

Shortly before the court's decision in the appraisal action, Exela, through its subsidiaries, entered into a \$160 million accounts receivable securitization facility. Under the facility, subsidiaries of SourceHOV sold their receivables to newly formed subsidiaries of Exela.

While an appeal of the appraisal action by SourceHOV was pending with the Delaware Supreme Court, the plaintiffs sent a demand letter to SourceHOV requesting the immediate payment of the judgment. The Chancery court then entered a charging order against SourceHOV's membership interest in its wholly owned subsidiary SourceHOV, LLC, directing that the plaintiffs' judgment be paid before any money moving through SourceHOV from its subsidiaries reached Exela, as the ultimate parent company of SourceHOV.

The plaintiffs in this case contended that the purpose of the facility was to bypass SourceHOV and directly reach Exela, thereby rendering the charging order worthless. They alleged a reverse veil-piercing claim seeking to hold Exela and the newly formed SourceHOV subsidiaries that sold their accounts receivables to the newly formed Exela subsidiaries liable for the judgment against SourceHOV, alleging that they were the alter egos of SourceHOV. The defendants filed a motion to dismiss, arguing that equitable remedies such as reverse veil-piercing are barred by the provision of Delaware law that states a charging order is the exclusive remedy for judgment creditors with respect to a member's LLC interests, and reverse veil-piercing is an equitable remedy that is not recognized under Delaware law.

After endorsing the availability of reverse veil-piercing as an equitable remedy under Delaware law, the court reviewed the relevant factors under the deferential pleading stage standard of review and held that the plaintiffs' reverse veil-piercing claim could proceed.

The *Manichaeen* ruling by the Court of Chancery raises the prospect that outsider reverse veil-piercing will become a feasible tool for third parties to reach otherwise unavailable assets that are stored in complex corporate structures. While Delaware courts closely scrutinize traditional veil-piercing claims, and will do the same with reverse veil-piercing claims, companies are now on notice that their downstream corporate structure is a potential source of recovery on a judgment in certain circumstances. Nevertheless, the best protection against veil-piercing claims (traditional or reverse) is still maintaining appropriate and well-functioning corporate governance and corporate separateness.