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Fiduciary, Fraud Claims Allowed to Proceed Against Business Sellers

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The Delaware Court of Chancery recently allowed claims involving breach of fiduciary duty and fraud against the sellers of a business to survive a motion to dismiss. The business provided non-legal administrative services to law firms and their mortgage lender clients in connection with mortgage foreclosures in a number of Western and Midwestern states. The organizational structure of the businesses was relatively complex and involved overlapping entities. The causes of action were seven in number and the court described the multiple motions to dismiss by the defendants as including a "somewhat dizzying array of arguments and counter-arguments."

The 61-page opinion in *CMS Investment Holdings LLC v. Castle*, C.A. No. 9468-VCP (Del. Ch. June 23, 2015), provides an extensive description of the facts. In essence, the claims for breach of the LLC agreement, breach of the implied covenant of good faith and fair dealing, unjust enrichment, breach of fiduciary duty, fraudulent transfer and related claims were based on an alleged scheme to deprive the purchaser of receiving the benefit of its bargain. In particular, the LLC that was created to receive the fees generated for administrative services was not being utilized in the manner intended by the parties. For example, instead of the fees being paid to the LLC, the defendants retained the fees for themselves, leading to the LLC's default on its debt obligations. Moreover, instead of helping the LLC to restructure, the defendants allegedly ushered it into insolvency and then bought the most valuable assets of the company from the LLC's receivership, the opinion said.

Several important legal principles and analyses with wide practical application are discussed in this opinion. For example, the court discusses the criteria to determine when a claim should be considered direct or derivative. The court explained that the following questions inform the determination: (1) who suffered the alleged harm (the corporation or the suing stockholders individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders individually). However, courts have long recognized that the same set of facts can give rise to both a direct claim and a derivative claim. In this case, the court found that the claims were at least dual claims that have both direct and derivative aspects, and thus were allowed to proceed on that basis.

The court described the types of fiduciary duty claims that could be derivative in nature and also noted several types of direct claims for infringement of a stockholder's right that are direct in nature, such as an infringement of the right to vote and the right to enforce contractual restraints on the authority of a board pursuant to the charter, bylaws or provisions of the Delaware General Corporation Law. Compare *NAF Holdings LLC v. Li & Fung (Trading) Ltd.*, 2015 Del. LEXIS 310 (June 24, 2015), a recent Delaware Supreme Court decision that held individual contractual rights are direct and not derivative even if a corporation might be a beneficiary of that contract.

The Chancery opinion in *CMS* includes a helpful articulation of the implied covenant of good faith and fair dealing, and an explanation of why and how, based on the facts of this case, that claim survived a motion to dismiss. The court emphasized the temporal focus as being critical in the analysis of such a claim. Thus, the court addressed what the parties would have agreed to themselves had they considered the issue in their original bargaining positions at the time of contracting.

The court provided a useful description of an unjust enrichment or quasi-contract claim juxtaposed with a breach of contract claim, and explained how those two claims can be pleaded in the alternative in the same complaint. Based on the facts of this case, the court reasoned that the unjust enrichment claim would proceed in the alternative.

Likewise, the court explained how a breach of a contractually-defined fiduciary duty claim can be pleaded compared to a conventional breach of contract claim. The court emphasized that a cause of action for aiding and abetting can only survive in connection with the former claim.

The court explained that the terms of the LLC agreement in this case did not eliminate all the fiduciary duties that could be eliminated under the LLC Act. The court observed that for those fiduciary duties that were not waived by the LLC agreement, there was a factual issue regarding whether the managerial responsibilities of certain of the individual defendants rose to the level that would impose upon them the default fiduciary duties provided for in the LLC Act.

In allowing a breach of fiduciary duty claim to proceed, and to survive a motion to dismiss, the court noted that there may be some situations where simply resigning from the board, without taking other action, may in some circumstances support a claim for breach of fiduciary duty.

In the concluding section, the court addressed a claim pursuant to the Delaware Uniform Fraudulent Transfers Act and allowed the claim for actual and constructive fraud to proceed pursuant to Sections 1304 and 1305 of the act. The court explained that the underpayment or diversion of fees that were properly payable to the LLC supported a claim that those actions were actually, or reasonably appeared to have been, made intentionally to hinder the interests of the plaintiff as a holder of equity and debt in that LLC, for less than reasonably equivalent value, while the LLC was in financial distress.

The court also emphasized that the DUFTA also allows principles of law and equity to supplement its statutory provisions, which formed an additional basis for the court's refusal to dismiss those claims.

In sum, this opinion efficiently distills complicated facts and a plethora of claims and defenses involving important principles and statements of Delaware law that have widespread applications.

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