Chicago Daily Law Bulletin

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August 1, 2016

Appellate court opens door for shareholders to sue despite insolvency

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On June 24, in a case of first impression, the 1st District Appellate Court held that the insolvency of a corporation does not prevent shareholders from bringing a derivative action but merely allows creditors to do so as well. The court also held that:

- The shareholders in that case could not pursue a derivative action due to conflicts between their personal interests and those of their fellow shareholders but that the court should give non-conflicted shareholders notice and the opportunity to assume the case before dismissing it; and
- Outside directors do not breach their fiduciary duties merely by resigning their office.

Edward M. Caulfield, et al. vs. The Packer Group Inc., et al., 10 CH 28475 (6th Div., June 24, 2016).

Facts

The Packer Group Inc. was a closely held corporation comprised of three wholly owned subsidiaries one of which was Packer Engineering Inc. (collectively, the "Packer Cos.").

On July 1, 2010, plaintiffs Edward Caulfield, a shareholder and the president and chief technical officer of PEI, and Michael Koehler, a shareholder and PEI's chief executive officer, filed a shareholders' derivative action on behalf of TPG and PEI against the inside directors, including Kenneth Packer, TPG's founder and board chairman.

In a subsequent amendment, they also asserted a breach of fiduciary duty claim against the outside directors.

Plaintiffs alleged that Packer had purchased New Vermillion Ironworks, an Illinois corporation, for his personal benefit, had financed the purchase from his personal line of credit, but later had transferred his personal debt to TPG without the knowledge or approval of plaintiffs or TPG's outside directors.

The complaint also accused Packer and certain other inside directors of a series of financial improprieties, including using TPG's assets secretly to fund the operation of New Vermillion Ironworks and taking money from TPG to which they were not entitled.

Plaintiffs also alleged that the defendants had blocked an internal investigation into their improper actions by withholding information from TPG's auditors and seeking to fire the plaintiffs.

Lower court dismisses action

The circuit court dismissed the claims against Packer and the inside directors pursuant to Section 2-619 of the Code of Civil Procedure on two separate grounds.

First, the court held that because the Packer Cos. were all insolvent, the shareholders were no longer entitled to bring a derivative action. The court held that only the creditors could bring such an action.

Second, the court held that because the plaintiffs had obtained substantial individual judgments against the defendants and were pursuing defendants' assets to satisfy those judgments, plaintiffs' personal interests conflicted with those of defendants' other creditors and, as a result, plaintiffs could not adequately represent the other creditors.

Standing to bring derivative claims

The Illinois Appellate Court reviewed the circuit court's dismissal de novo because it was based on issues of law. The first legal issue was whether a corporation's insolvency during the pendency of a shareholders' derivative action divests the shareholders of standing to pursue that derivative action. The court noted that this was an issue of first impression in Illinois and that it would look to decisions in other jurisdictions, particularly Delaware, for guidance.

The court said that several Delaware cases have held that the insolvency of a corporation does not turn derivative claims into direct creditor claims but simply provides creditors with standing to assert those claims as well. It quoted one Delaware decision which stated that:

"At all times, claims of this kind belong to the corporation itself because even if the improper acts occur when the firm is insolvent, they operate to injure the firm in the first instance by reducing its value, injuring creditors only indirectly by diminishing the value of the firm and therefore the assets from which the creditors may satisfy their claims."

Production Resources Group LLC v. NCT Group Inc., 863 A.2d 772, 776 (Del. Ch. 2004).

The court noted that the majority of cases outside Delaware also "hold that shareholders maintain standing, along with creditors, to bring derivative claims on behalf of insolvent corporations." It cited several Illinois cases which, though not directly on point, hold that when a corporation becomes insolvent, the fiduciary duties of its officers extend to the corporation's creditors.

The court interpreted these cases to mean that insolvency expanded the persons to whom fiduciary duties were owed. The logical consequence of this was that creditors gained the right to bring a derivative action, not that shareholders lost that right.

Conflict of interest

The court then examined the second basis for the circuit court's dismissal of the case: the plaintiffs' alleged conflict of interest. Here too, the court noted an absence of Illinois case law "setting forth the factors to consider when determining whether such a conflict exists." Again it turned to Delaware law for guidance and, in particular, noted the factors listed in *Emerald Partners v. Berlin*, 564 A.2d 670, 673 (Del. Ch. 1980).

Though the *Berlin* decision sets out several factors in assessing self-interest, the most relevant here is whether the would-be plaintiffs have a pecuniary interest that conflicts with other shareholders.

Application of that factor to the case was straightforward. The individual plaintiffs had won substantial judgments against TPG, PEI and other defendants and were acting "to collect the remaining assets of the insolvent corporate defendants TPG and PEI [for themselves] at the expense of the shareholders in the derivative action."

Accordingly, the court held that the plaintiffs' self-interest created a conflict that prevented the plaintiffs from representing the other shareholders.

Because the circuit court had held that only creditors could bring a derivative action on behalf of the Packer Cos., the circuit court had directed the plaintiffs to notify the creditors of the dismissal of the plaintiffs' derivative case and their right to intervene.

The appellate court modified that dismissal order to require plaintiffs to notify the other shareholders of the dismissal of the plaintiffs' case and their right to intervene to carry on the suit.

Claim against outside directors based on their resignations

The plaintiffs had alleged that the outside directors of TGP violated their fiduciary duties by resigning because they failed to complete their investigation into the financial misconduct of the inside directors and their absence enabled Packer to continue to exercise control over the Packer Cos. and to do further harm.

However, the plaintiffs' amended complaint pleaded facts showing that the outside directors had tried to conduct a financial investigation, their efforts had been stymied by Packer, they had demanded but failed to obtain Packer's resignation, and, when faced with Packer's statements indicating that he would limit the information provided to the auditors, they had resigned.

Assuming the facts in the plaintiffs' complaint to be true and noting the absence of any evidence or allegation that the outside directors engaged in any actions that caused harm after they resigned, the appellate court affirmed the dismissal of the claims against them.

The appellate court refused to grant the plaintiffs the right to amend, ruling that the circuit court had not abused its discretion in dismissing the claims against the outside directors with prejudice because the plaintiffs had never tendered a potential amendment that would have cured the defects in those claims.

Conclusion

The most important ruling in the *Caulfield* case is its holding that a corporation's insolvency does not prevent shareholders from bringing a derivative action.

Instead, once a company becomes insolvent, shareholders and creditors both have standing to bring derivative claims. The practical reason this ruling is important is because shareholders often may have more incentive than creditors to bring derivative claims to redress corporate wrongdoing.

They also may have more information than creditors about whether such claims have merit.

In addition, shareholders who also serve as directors or company officers sometimes may need the right to bring a derivative action to protect themselves from liabilities created by the misconduct of other corporate actors.