insights

SHUMAKER
Shumaker, Loop & Kendrick, LLP

A Newsletter from Shumaker, Loop & Kendrick, LLP | Fall 2014

A Derivative Suit by Any other Name: Challenging Manager Actions in Alternative Entities

When the shareholders of a corporation allege that the corporation's management has committed a wrong and thereby injured the shareholders, their injuries can be direct or indirect. By way of example, if a director of a corporation wrongfully prevents a shareholder from voting his/her shares in a vote, then that shareholder has suffered a direct harm and may bring suit directly against the corporation. However, if a shareholder alleges that a director violated a fiduciary duty to the corporation, which caused harm to the corporation itself, then this harm would be indirect, and the shareholder would have to bring a derivative claim against the corporation. Therefore, if a director with a conflict of interest were to sell goods to the corporation at inflated prices, the shareholders, as owners of the corporation, would suffer a harm, which would be redressed through a derivative lawsuit. In practice, the exact line between direct and indirect harm can be difficult to define. However, the distinction between direct and derivative claims is extremely important, as the procedural requirements and available remedies are distinct. For example, an unwary plaintiff who mischaracterizes a derivative cause of action as direct bears the risk of having its claim dismissed. *E.g.*, *Marcoux v. Prim*, 04 CVS 920, 2004 NCBC 5, at ¶ 36–38 (N.C. Bus. Ct. Apr. 16, 2004).

By Joshua M. Hayes

The distinction between direct and derivative claims is extremely important, as the procedural requirements and available remedies are distinct.

Further complications arise when courts attempt to apply this framework to alternative entities, such as limited partnerships and limited liability companies, whose rights are defined principally by contract rather than statute. While courts often look to

corporate law for guidance, there are important distinctions between the law of corporations and the law of alternative entities. For example, in 2010, a Delaware Chancery court held that, unlike corporate creditors, a creditor of an LLC does not have standing to assert a derivative claim against an insolvent LLC. *See CML V, LLC v. Bax*, C.A. No. 5373-VCL (Del. Ch. Nov. 3, 2010); see also *Weinstein v. Colborne Foodbotics, LLC*, 2013 CO 33, 302 P.3d 263 (Colo. 2013) (reaching the same conclusion and holding that limited liability company acts need not be strictly construed to the extent that they deviate from common law, as such deviation "indicates the legislature intended that the LLC Act, not corporation common law, would govern LLCs"). Because alternative entities such as partnerships and LLCs are creatures of contract, courts often reach divergent conclusions on the extent to which members of these entities may assert derivative claims.

Such was the legal landscape when the Delaware Court of Chancery decided *Allen v. El Paso Pipeline GP Co.*, CIV.A. 7520-VCL, 2014 WL 2819005 (Del. Ch. June 20, 2014). In *Allen*, a class of investors brought suit against an El Paso Corporation subsidiary, El Paso Pipeline Partners L.P., a publicly traded Delaware master limited partnership (the "Partnership Subsidiary"), over the Partnership Subsidiary's $895 million acquisition of a 25% stake in Southern Natural Gas Company. Because El Paso Corporation effectively maintained a controlling interest in the Partnership Subsidiary's general partner and owned the interest in Southern Natural Gas Company that the Partnership Subsidiary would acquire, the proposed transaction created a conflict of interest for the Partnership Subsidiary's general partner.

Although the Partnership Subsidiary's limited partnership agreement ("LPA") eliminated all common law fiduciary duties that the general partner owed to the Partnership Subsidiary's limited partners, the LPA provided procedures for consummating transactions that involve a conflict of interest. After the acquisition, plaintiff challenged the transaction on the grounds that the defendants breached the express terms of the LPA and that the general partner's board of directors (the "Board") aided and abetted the general partner's breach, asserting that the committee appointed by the general partner's board did not evaluate the transaction in good faith and had overpaid for the acquisition. The Board challenged these claims on the grounds that they were derivative claims and therefore inapplicable in the context of a limited partnership whose LPA had abolished common law fiduciary duties.

The Court focused on the issue of whether the claims were direct or derivative, and, relying on the standard set forth in *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, 845 A.2d 1031 (Del. 2004), found that the claims were not exclusively derivative and could support a direct characterization because the limited partners had suffered a direct injury to their contractual rights under the LPA, specifically, the right to a good faith approval of a transaction involving a conflict of interest. The court also analogized to corporate law, noting that, as a shareholder can directly assert that a board of directors had exceeded its discretionary authority, a limited partner can directly assert that a general partner exceeded its authority. Because the court held these to be direct claims, it held that the plaintiff had standing as a party to the LPA to pursue the claim for breach of contract directly.

Ultimately, the Court found for the defendants, entering summary judgment in their favor. The Court held that the Board's actions must be evaluated based on their subjective belief that they were acting in the Partnership Subsidiary's best interests, and the evidence did not suggest that the Board subjectively believed that they were not complying with the standard of conduct outlined in the LPA.

The upshot is that *Allen* should serve as a reminder to managers of partnerships and limited liability companies that members of such entities can potentially bring claims that are similar to derivative actions in the corporate context as a result of the often blurry line between direct and derivative actions. Further, as was the case in *Allen*, the outcome of these cases is often contingent on the specific language contained in the entity's operating agreement, and so careful drafting and review of such agreements is critical, especially in the context of acquisitions or mergers. This is particularly true in North Carolina because the new North Carolina Limited Liability Company Act specifically provides that members are free to agree on the manner in which disputes related to an LLC and their interests in the LLC are to be resolved, including eliminating the right or requirement to bring a derivative action. See N.C. Gen. Stat. § 57D-2-30(b)(5).

For more information, contact Josh Hayes at jhayes@slk-law.com or 704.945.2925.