YetterColeman LLP
TRIALS | APPEALS

I Love You, I Love You Not: Texas Courts' Treatment of Delaware Law on Derivative Claims

Rebecca Phelps
Associate
713.632.8016
rphelps@yettercoleman.com

I. Introduction

Creditors' ability to bring derivative claims against directors and officers for breach of fiduciary duty is rapidly diminishing in Texas. Until recently, Texas courts have generally followed Delaware law in allowing creditors to bring derivative claims when a company is insolvent but still operating.[1]

However, in the most recent opinion on the subject, *Aurelius Capital Master, Ltd. v. Acosta,*[2] a federal district court in the Northern District of Texas rejected Delaware's approach and held that creditors may only bring derivative claims for breach of fiduciary duty once the company is insolvent *and* has ceased operations. Moreover, *Aurelius* criticized the previous opinions from Texas courts as confusing Delaware law for Texas law, stating "[w]hile Delaware's corporate law is certainly influential, the decision to alter Texas law remains with Texas courts." [3]

To truly understand the importance and impact of the *Aurelius* decision and its rejection of Delaware law, it is necessary to conduct a brief review of Delaware's recent jurisprudence on derivative claims by creditors. By contrasting Texas law with Delaware law, the leading law in the country on creditor claims, parties will appreciate just how limited creditors are in their ability to bring fiduciary duty claims against directors and officers in Texas.

II. Under Delaware Law, Creditors May Bring Derivative Claims Once the Corporation is Insolvent

Suits for breach of a fiduciary duty can be either direct or derivative. In a direct suit, the plaintiff sues a defendant for violation of a duty owed to the plaintiff. In contrast, a derivative suit is for the violation of a duty owed to the corporation, but the duty is being enforced by the plaintiff. Derivative suits are typically the province of shareholders.[4]

[1] *See, e.g., In re I.G. Services*, *Ltd.*, 04-5041-C, 2007 WL 2229650, at *4 (Bankr. W.D. Tex. July 31, 2007) and *In re VarTec Telecom, Inc.*, 04-81694-HDH-7, 2007 WL 2872283, at *3 (Bankr. N.D. Tex. Sept. 24, 2007).

[2] 3:13-CV-1173-P, 2014 WL 10505127, at *2 (N.D. Tex. Jan. 28, 2014).

[3] *Aurelius,* 2014 WL 10505127, at *5.

[4] *See* Tex. Bus. Orgs. Code § 21.552 (setting statutory requirements for a shareholder to bring a derivative suit under Texas law); Fed. R. Civ. P. 23.1 (establishing procedural rules for derivative actions that apply to shareholders broadly).

Under certain circumstances, however, creditors may stand in the shoes of shareholders and bring derivative suits.[5]

In *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, the Delaware Supreme Court recognized that creditors have standing to bring derivative claims against directors and officers for breaches of fiduciary duties once the corporation is insolvent.[6] Because the holding in *Gheewalla* primarily dealt with direct claims,[7] the court did not squarely address whether creditors may bring derivative claims when the corporation is in "the zone of insolvency." The dicta in the opinion, however, strongly suggests that only shareholders, not creditors, may bring a derivative claim while the company is operating in the zone of insolvency. "When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its *shareholders* by exercising their business judgment in the best interests of the corporation for the benefit of its *shareholder* owners." [8]

III. Under Recent Texas Law, Creditors Are Limited to Bringing Derivative Claims Only When the Corporation is Insolvent *and* Has Ceased Operations

Despite the general acceptance in Texas of *Gheewalla's* bar on direct claims by creditors, Texas courts have been less unified on *Gheewalla's* position regarding derivative claims. Historically, Texas courts have adhered to the "Trust Fund Doctrine" to determine when a creditor may bring any suit (direct or derivative) against a corporation. Under the Trust Fund Doctrine, "the assets of an *insolvent* corporation, which has *ceased to carry on business*, and does not intend to resume" become a trust fund for the benefit of the creditors, thus giving creditors rights similar to those of a trustee.[9] In other words, Texas courts have permitted creditors to sue for breach of fiduciary duty (similar to the action available of a trust beneficiary), but only once the corporation is actually insolvent *and* it has ceased operations.[10]

Prior to *Aurelius*, Texas courts generally followed *Gheewalla* by allowing creditors to bring such claims when the corporation was insolvent but still operating. *See, e.g., In re I.G. Services*, *Ltd.,* 2007 WL 2229650, at *4 (applying Texas law and holding that creditors' claims for breach of fiduciary duty against directors could not stand as a direct action, but only as a derivative action); *In re VarTec Telecom, Inc.,* 2007 WL 2872283, at *3 (recognizing a Texas cause of action for breach of fiduciary duty against the directors or officers of a corporation may be brought by the creditors of a corporation when the corporation is merely insolvent).

[5] *Aurelius*, 2014 WL 10505127, at *2.

[6] *Gheewalla*, 930 A.2d 92, 101 (Del.2007).

[7] The court held that creditors may never bring *direct* claims against directors and officers for breach of fiduciary duty, regardless of whether the corporation is in the zone of insolvency or actually insolvent. This is because directors and officers never owe direct fiduciary duties to creditors, only to the corporation.

[8] *Id.* at 101. (emphasis added).

[9] *Lyons–Thomas Hardware Co. v. Perry Stove Mfg. Co.*, 86 Tex. 143, 158, 24 S.W. 16, 21 (1893).

[10] *Fagan v. La Gloria Oil & Gas Co.*, 494 S.W.2d 624, 628 (Tex.Civ.App.1973).

In contrast, *Aurelius* departed sharply from Delaware law by holding that creditors may *not* bring derivative claims for breach of fiduciary duty when a company is merely insolvent, but still operating.[11] Instead, the court found that creditors may only bring a derivative claim under the Trust Fund Doctrine, meaning the corporation must be insolvent and must have ceased all operations.[12] *Aurelius* dramatically narrows the rights of creditors as compared to the prior Texas opinions that permitted creditor derivative claims upon mere insolvency.

Without direction from the Texas Supreme Court, it remains to be seen which line of cases will become the outlier. *Aurelius* acknowledges its inconsistency with prior holdings and criticizes *In re I.G. Services*, *Ltd.* and *In re VarTec Telecom, Inc*. as relying too heavily on Delaware law.

But *Aurelius* also recognizes the dearth of Texas authority on the issue. "Neither the parties nor the Court could locate Texas Supreme Court precedent that squarely addresses whether creditors can bring a derivative suit upon mere insolvency."[13] *Aurelius* found that the lack of Texas precedent cut against the creditors' position. This is notable because *Aurelius* is the most recent decision on the issue.

Until this area of law is settled, one way to avoid this murky issue is for trustees to bring breach of fiduciary duty claims in the name of the company. This strategy has proven effective in avoiding the question of when creditors may bring derivative claims. In *Floyd v. Hefner*,[14] the court initially held that directors owe no fiduciary duties to creditors outside of the Trust Fund Doctrine. In response, the Trustee amended the complaint by merely substituting the name of the corporation for that of the Trustee as the plaintiff. This one change allowed the claims to go forward on rehearing because directors and officers always owe fiduciary duties to the corporation itself.[15]

Notwithstanding this workaround, creditors looking to bring breach of fiduciary duty claims against directors and officers in Texas should beware of the recently tightened restrictions on derivative claims. As a practical matter, *Aurelius'* narrowing of derivative claims to only situations of insolvency *and* liquidation render such claims a limited tool for creditors in Texas.

Rebecca Phelps focuses her practice on complex commercial litigation. She graduated from Stanford Law School with Pro Bono Distinction for her extensive public service while attending law school. Becky held clerkships with the U.S. Attorney Office, Northern District of California, the Santa Clara County District Attorney's Office, the Securities and Exchange Commission in New York, and the Office of California Attorney General. A Surface Warfare Officer in the United States Navy, Becky served for five years of active duty before transitioning into the Navy Reserve in 2012. She graduated from the United States Naval Academy, with Merit.

---

[11] *Aurelius,* 2014 WL 10505127, at *5.

[12] *Id. See also Floyd v. Hefner*, CIV.A. H-03-5693, 2006 WL 2844245, at *19 (S.D. Tex. Sept. 29, 2006), *on reconsideration in part on other grounds*, 556 F. Supp. 2d 617 (S.D. Tex. 2008) ("Texas law imposes [no] general fiduciary duty on the directors of a corporation in favor of that corporation's creditors outside the narrow boundaries of the trust fund doctrine.").

[13] *Aurelius,* 2014 WL 10505127, at *3.

[14] 556 F. Supp. 2d 617, 629 (S.D. Tex. 2008).

[15] *Id*. at 634.