AN "UNJUSTIFIABLE" STANDARD: PLEADING DEMAND FUTILITY AS A CREDITOR OF AN INSOLVENT CORPORATION

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It is well understood that under Delaware law, a stockholder attempting to sue derivatively on behalf of a corporation must first do one of two things: (1) make a pre-suit demand on the corporation's board to pursue the cause of action, which demand must have been wrongfully refused; or (2) allege in its complaint—with particularity—why such a demand would have been futile.[1] It is also settled in Delaware that when the corporation is insolvent, its creditors gain standing to serve as a derivative plaintiff.[2]

The law is unclear, however, as to whether a creditor seeking to enforce an insolvent corporation's rights must comply with the demand and demand futility pleading requirements applicable to stockholders. What's more, if a creditor-plaintiff is subject to the demand or demand futility requirement, what standard is a court to apply to review the adequacy of a creditor's pleading? These issues are of significant importance because failure to adequately allege demand or demand futility when required may result in dismissal of the plaintiff's lawsuit.

This article submits that a creditor-plaintiff should be required to make a demand on the board or explain its failure to do so as a prerequisite to litigating a derivative suit. The rationale for the demand requirement—that only the board of directors possesses the authority to assert the corporation's claims—applies equally, if not more, where the corporation is insolvent. This rationale counsels for a governor on creditors' ability to sue derivatively.

But where the creditor-plaintiff chooses the demand futility route, it should not be required to satisfy the heightened pleading requirements imposed on stockholders by Court of Chancery Rule 23.1 ("Rule 23.1") and the case law interpreting that rule. Pleading demand futility with particularity presents several practical and theoretical concerns for the creditor-plaintiff that traditional stockholder-plaintiffs do not share. Creditors lack access to the pre-suit discovery often necessary to establish the particulars of directors' conflicts of interest—an essential component of the demand futility test under *Aronson*.[3] Further, directors of distressed corporations may be motivated to decline to suit authorization because the corporation may not be able to advance or indemnify defense costs, but it is not clear that an allegation of such motivation would alone rise to the level necessary to excuse a demand. Moreover, the concepts of demand and demand futility have no real theoretical underpinning where a creditor is the plaintiff because the creditor did not elect, and cannot remove, the directors they must confront. For those reasons, Rule 23.1 is an inappropriate procedural implementation of the substantive rationale of board primacy in the insolvency context.

Instead of forcing creditor-plaintiffs to adhere to the pleading requirements tailored for stockholder-plaintiffs, Delaware state courts should follow the lead of the Third Circuit Court of Appeals and Delaware bankruptcy courts by adopting the bankruptcy courts' standard and procedure for determining whether creditors may sue derivatively on behalf of a debtor corporation. This standard, referred to herein as the *Cybergenics* rule, requires a creditor-plaintiff to affirmatively

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1. Aronson v. Lewis, 473 A.2d 805 (Del. 1984).

2. N. Am. Catholic Educ. Programming Found. v. Gheewalla, 930 A.2d 92 (Del. 2006)

3. *Aronson*, 473 A.2d at 814.

obtain a court order finding that the creditor has alleged "colorable" claims and the board has (or would have) "unjustifiably" refused to pursue them.[4] The *Cybergenics* rule better balances the competing rights of directors and creditors of an insolvent corporation because creditors will not be burdened with the steep, if not impossible, task of marshaling "particularized" facts regarding directors' ability to exercise independent business judgment without the benefit of the pre-suit discovery tools available to stockholders. At the same time, the corporation will be able to rely on the court (applying the deferential business judgment rule, where appropriate) to serve as a gatekeeper against improper suits. Moreover, application of the *Cybergenics* rule will promote uniformity of law in this area, while still allowing considerable room for analysis of the particular facts and circumstances and weighing of equities, a task that is well-suited for Delaware's Court of Chancery.

This article begins with an overview of Rule 23.1 and the demand and pleading requirements applicable to stockholder-plaintiffs. With this background, the article turns to decisions of the Court of Chancery that raise the question of whether the requirements applicable to stockholders also apply to a creditor-plaintiffs. Because those cases admit that Delaware law is not clear on this point, this article next turns to an analysis of the substantive rule of law underlying the demand requirement and the procedural implementation of it via Rule 23.1. Finally, this article proposes and discusses the *Cybergenics* standard that could be applied instead of existing demand and pleading requirements where a creditor is the derivative plaintiff.

I. THE DEMAND REQUIREMENT AND CHANCERY RULE 23.1, GENERALLY

The demand requirement—i.e., the requirement that a would-be derivative plaintiff first "demand" that the board of directors pursue the corporation's claim—is rooted in the bedrock principle of Delaware law that the board of directors, and not any other corporate constituency, possesses the authority to manage a corporation's business and affairs, including its potential causes of action.[5] Section 141(a) of the Delaware General Corporation Law (the "DGCL") provides that "[t]he business and affairs of every corporation organized under [the DGCL] shall be managed by or under the board of directors."[6] "The requirements of demand futility or demand refusal flow from Section 141(a), which makes the authority of the board of directors paramount."[7]

As the Delaware Supreme Court stated in its seminal opinion in *Aronson v. Lewis*, "the entire question of demand futility is inextricably bound to issues of business judgment."[8] By extension, the *Quadrant I* court explained:

> A corporate claim is an asset of the corporation, so authority over the claim ordinarily rests with the board of directors. The doctrines of demand excusal and demand refusal protect the board's authority under Section 141(a) and prevent a derivative plaintiff from usurping the board's prerogative to decide how to handle a corporate claim.[9]

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4. Official Committee of Unsecured Creditors of Cybergenics Corp. ex rel. Cybergenics Corp. v. Chancery, 330 F.3d 548 (3d Cir. 2003).

5. *See* 8 Del. C. § 141(a).

6. *Id.*

7. Quadrant Structured Prods. Co. v. Vertin, 102 A.3d 155, 182 (Del. Ch. 2014) ("*Quadrant I*").

8. *Aronson*, 473 A.2d 805, 812 (Del. 1983).

9. *Quadrant I*, 102 A.3d at 181 (citations omitted).

Rule 23.1 implements Section 141(a)'s substantive rule of law.[10] Rule 23.1 provides the procedural requirement that the underlying complaint "allege *with particularity* the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort."[11]

A well-developed body of case law explains Rule 23.1's demand futility pleading requirements. Not surprisingly, given the *Aronson* court's linking of demand futility to the concept of business judgment, the tests used to determine whether demand futility has been established focus on whether a plaintiff has pleaded that directors are incapable of exercising, or have failed to exercise, sound business judgment.[12] Specifically, when a plaintiff proposes to challenge a particular corporate transaction, Rule 23.1 requires the court to determine "whether, under the particularized facts alleged, a reasonable doubt is created that (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment."[13] Alternatively, the Delaware Supreme Court in *Rales v. Blasband* explained that where a particular corporate transaction is not at issue, the plaintiff must plead particularized factual allegations that "create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand."[14]

Rule 23.1 is appropriately described as imposing a "heightened pleading standard" upon a derivative plaintiff.[15] The requirement that demand futility be pled "with particularity" is stressed throughout the Delaware cases.[16] Derivative plaintiffs are often cautioned that "[c]onclusory allegations are not considered as expressly pleaded facts or factual inferences."[17] Further, although a derivative plaintiff will be given the benefit of all reasonable inferences, "[s]uch reasonable inferences must logically flow from particularized facts alleged by the plaintiff."[18]

Importantly for would-be plaintiffs, the courts are clear that "[w]here the plaintiff fails to comply with the demand requirement and fails to plead with particularity why a demand would be futile, the complaint will be dismissed."[19]

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10. *See id.* ("Rule 23.1 implements the substantive requirements of demand futility and demand refusal as pleading requirements….").

11. Del. Ch. R. 23.1 (emphasis added).

12. *See, e.g.*, In re Walt Disney Co. Derivative Litig., 731 A.2d 342 (Del. Ch. 1998).

13. *Aronson*, 473 A.2d at 814.

14. Rales v. Blasband, 634 A.2d 927, 934 (Del. 1993).

15. *See* South v. Baker, 62 A.3d 1, 14 (Del. Ch. 2012); *see also* Brehm v. Eisner, 746 A.2d 244, 254 (Del. 2000) (acknowledging that Rule 23.1 imposes a more rigorous pleading requirement than Rule 12(b)(6)).

16. *See, e.g.*, Beam v. Stewart, 845 A.2d 1040, 1049 (Del. 2004); *South*, 62 A.3d at 26.

17. *Beam*, 845 A.2d at 1048 (internal quotation marks omitted).

18. *Id.*

19. Tvi Corp. v. Gallagher, 2013 Del. Ch. LEXIS 260, *18 (Del. Ch. June 3, 2013); *see, e.g.*, *South*, 62 A.3d at 6 (dismissing derivative complaint "with prejudice and without leave to amend as to the named plaintiff" for failure to adequately plead demand futility under Rule 23.1).

II. DELAWARE LAW IS UNCLEAR AS TO WHETHER CREDITORS MUST PLEAD DEMAND FUTILITY

Currently, "[i]t is…possible that creditors may be required to comply with the doctrines of demand futility and demand excusal."[20] Although the Delaware Supreme Court's 2006 decision in *North American Catholic Education Programming Foundation v. Gheewalla* resolved long-standing uncertainty regarding the fiduciary relationship between the directors of an insolvent corporation and the creditors of that corporation,[21] neither *Gheewalla* nor its progeny provide guidance on secondary issues regarding the mechanics of creditor-plaintiff's derivative suit.

Eight years after *Gheewalla*, the Court of Chancery first addressed a subset of the procedural issues facing a creditor-plaintiff proceeding under Rule 23.1. In *Quadrant Structured Prods. Co. v. Vertin*, the court examined whether the creditor-plaintiffs, like shareholder-plaintiffs, are limited to suing for harms that occurred while they were creditors, a limitation known as the "contemporaneous ownership" requirement.[22] The court rejected a "contemporaneous ownership" requirement for creditor-plaintiffs.[23] Months later, in a related opinion, the court also rejected a "continuous insolvency" requirement, holding that a return to solvency after the complaint is on file does not divest the creditor of derivative standing.[24]

Both of the *Quadrant* decisions indicate that Delaware courts do not necessarily view creditors and stockholders as equivalent derivative plaintiffs, nor are the rules necessarily interchangeable. Thus, the possibility remains that a creditor-plaintiff may *not* be required to comply with the doctrines of demand futility and demand excusal.

The uncertainty regarding a creditor-plaintiff's obligation to satisfy the demand rules applicable to stockholders arises in large part because, although it would stand to reason that the demand rule would apply to a creditor-plaintiff, Rule 23.1 by its plain terms applies only to derivative actions "brought by one or more *shareholders* or members to enforce a right of a corporation or an unincorporated association."[25] Indeed, the Court of Chancery recently recognized that "Rule 23.1 does not mention creditor-plaintiffs when addressing either contemporaneous ownership or demand futility and demand refusal."[26]

Moreover, in rejecting a "contemporaneous ownership" requirement for creditor-plaintiffs in *Quadrant I*, the Court of Chancery held that Rule 23.1's reference to "shareholders" was unambiguous.[27] The rule's requirement that "the complaint allege that the plaintiff was a shareholder or member at the time of the transaction of which the plaintiff complains…." cannot be reasonably read to apply to a creditor-plaintiff.[28] Although the court's ruling was technically grounded

20. *Quadrant I*, 102 A.2d at 182.

21. *See Gheewalla*, 930 A.2d at 99-103; *Quadrant I*, 102 A.3d at 172-76.

22. *Quadrant* I, 102 A.3d at 177-82.

23. *Id.* at 179-80.

24. Quadrant Structured Prods. Co., Ltd. v. Vertin, 115 A.3d 535 (Del. Ch. 2015).

25. Del. Ch. R. 23.1 (emphasis added).

26. *Quadrant I*, 102 A.3d at 181.

27. *Id.* at 179.

28. Del. Ch. R. 23.1(a); *see Quadrant I*, 102 A.3d at178-180.

in the language of Section 327 of the DGCL, which provides the substantive basis for the contemporaneous ownership rule, Section 327 and Rule 23.1 use identical language and the court held that by its terms, that language "applies only to stockholders. The plain language of the statute does not apply to other corporate constituencies, like creditors, who can under limited circumstances bring derivative claims."[29]

By refusing to extend the contemporaneous ownership requirement to creditors based on a plain reading of the word "shareholders," *Quadrant I* could be read as support for the proposition that a creditor suing derivatively on behalf of an insolvent corporation need not allege demand futility.[30] Under *Quadrant I*, the word "shareholder" in Rule 23.1 means just that—it does not include a creditor suing derivatively on behalf of an insolvent corporation.

Yet, despite interpreting the "plain language" of Section 327 (and, therefore, Rule 23.1) to apply only to shareholders, Vice Chancellor Laster paused to explain that *Quadrant I*'s rationale "does not preclude a requirement that creditor-plaintiffs comply" with the doctrines of demand futility and demand excusal."[31] The court made clear that its holding regarding the contemporaneous ownership rule relies on an important distinction between the substantive mandate of Section 327 and the procedural requirements of Rule 23.1. Extending this substantive-versus-procedural distinction to the demand context, the court stated that because Rule 23.1 is only procedural, "whether a creditor would need to satisfy the demand excusal or demand refusal requirements depends not on Rule 23.1 but rather on the underlying substantive principle of law."[32] In the contemporaneous ownership context, the "substantive principle of law," as noted, is supplied by Section 327 of the DGCL, and that statute plainly only applies to "shareholders."[33] In the demand context, however, Rule 23.1 does not have a corresponding statute that speaks directly to who must plead demand futility.[34] Rather, as discussed, "[t]he requirements of demand futility or demand refusal flow from Section 141(a)" of the DGCL,[35] which provides only that "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the board of directors."[36]

Although Delaware's General Assembly is free to craft a statute to delineate the contours of the demand and demand-futility requirements for creditor-plaintiffs, without such guidance, the courts will be left to analyze existing case law and the policy and purpose of those requirements to determine the standard that creditor-plaintiffs must meet. Until such time when that standard is clarified, uncertainty surrounds a putative creditor-plaintiff who seeks to sue derivatively.

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29. *Quadrant I*, 102 A.3d at 179.

30. *Id.* at 177-81.

31. *Id.* at 181.

32. *Id.* at 182.

33. *See* 8 Del. C. § 327; *Quadrant I*, 102 A.3d at 178-80.

34. *See* 8 Del. C. §§ 321-330.

35. *Quadrant I*, 102 A.3d at 182.

36. 8 Del. C. 141(a).

III. THE RATIONALE OF THE DEMAND REQUIREMENT APPLIES EQUALLY WHEN A CREDITOR IS THE PLAINTIFF

Delaware case law provides no direct guidance on the issue of whether a creditor-plaintiff must plead demand futility.[37] Although the Court of Chancery has raised the issue *sua sponte* on at least two occasions, in both cases the court was not required to resolve it.[38]

As discussed above, however, Delaware courts have said much about the rationale behind the demand requirement: "The doctrines of demand excusal and demand refusal protect the board's authority under Section 141(a) and prevent a derivative plaintiff from usurping the board's prerogative to decide how to handle a corporate claim."[39]

The rationale of the demand requirement applies equally when the plaintiff is a creditor. As an initial matter, the fact that the corporation is insolvent does not provide a legal basis to allow a plaintiff to bypass the board in asserting the corporation's claims. A board's managerial authority under Delaware law does not diminish or change upon insolvency.[40] To the contrary, the Court of Chancery has repeatedly stated that "[n]otwithstanding a company's insolvency, '[t]he directors continue to have the task of attempting to maximize the economic value of the firm.'"[41] Likewise, directors do not necessarily become interested or lose independence upon insolvency; consequently, informed and loyal directors of an insolvent corporation continue to be protected by the business judgment rule. According to the Court of Chancery: "'If the board of an insolvent corporation, acting with diligence and good faith, pursues a business strategy that it believes will increase the corporation's value'…'the directors are protected by the business judgment rule.'"[42] Therefore, since "the entire question of demand futility is inextricably bound to issues of business judgment,"[43] and the rules of business judgment do not change merely because a corporation is insolvent, the demand requirement should be equally applicable to a creditor-plaintiff as a matter of law.

Moreover, the policy rationale underlying the demand requirement and the business judgment rule—promoting corporate efficiency through centralized and informed decision-making—may be even more appropriate in the context of an insolvent corporation.[44] Creditors of a distressed entity are already incentivized to run to the courthouse to seize

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37. *See Quadrant I*, 102 A.3d at 182 ("This court has previously declined to address whether a creditor seeking to bring a derivative action must comply with the requirement to show demand excusal or demand refusal…."); Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 796 (Del. Ch. 2004). ("An independent review of Delaware precedent reveals nothing on point….").

38. *See Quadrant I*, 102 A.3d at 182; *Prod. Res. Group*, 863 A.2d at 796.

39. *Quadrant I*, 102 A.3d at 181 (citations omitted).

40. *See Quadrant I*, 102 A.3d at 185-86.

41. *Id.* at 185 (quoting *Prod. Res.*, 863 A.2d at 791).

42. *Id.* at 186 (quoting Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 174 (Del. Ch. 2006) and Shandler v. DLJ Merchant Banking, Inc., 2010 Del. Ch. LEXIS 154 (Del. Ch. July 26, 2010)).

43. *Aronson*, 473 A.2d at 812.

44. *Cf. Gheewalla*, 930 A.2d at 100 ("[A]n otherwise solvent corporation operating in the zone of insolvency is one in most need of effective and proactive leadership.").

control of potentially valuable corporate assets. Where cash and other tangible or unencumbered assets are scarce, the ability to control a corporate cause of action would provide the creditor with additional, unbargained-for leverage against the corporation and its other creditors, which the plaintiff-creditor would almost certainly use to extract preferential treatment. Compounding this risk is the likelihood that numerous creditors would likely seek such leverage at once. All of this would occur at a time when the corporation is most vulnerable, threatening to further jeopardize prospects for recovery. If Delaware law is to afford directors the leeway to manage a sinking ship, they should not be worried about creditors hijacking it.[45]

The lack of a demand requirement for creditors would also give creditors an unjustified advantage over the corporation's stockholders, who must continue to abide by the demand requirement and Rule 23.1 if they wished to pursue the same claim as the creditor. During the time that the putative stockholder-plaintiff must spend making a demand or discovering the particularized facts necessary to plead demand futility, a creditor could file suit.

In light of these concerns, the importance of the board's managerial authority under Delaware law, and the lengths to which the Court of Chancery went to insert *dicta* into the *Quadrant I* opinion solely to caution against the logical application of its holding to the demand futility requirement, extension of the demand requirement to derivative creditor-plaintiffs seems inevitable and would be appropriate. But, barring any legislative developments or an amendment to Rule 23.1, imposition of a demand-futility *pleading* requirement for creditors would require either (1) a judicial interpretation of Rule 23.1 that extends that rule to creditors; or (2) a judicially crafted demand futility rule applicable only in the creditor-suing-derivatively context. The first option does not appear tenable. Extending Rule 23.1's demand requirements to "creditors" would, in light of the "plain language" analysis of *Quadrant I*, create an inconsistent interpretation of the word "shareholder" depending on the pleading requirement at issue (i.e., "contemporaneous ownership," or "demand futility"). Additionally, as discussed below, extending Rule 23.1 and the case law applying it to creditor-plaintiffs poses several practical and theoretical problems.

IV. THE PROCEDURAL REQUIREMENTS OF RULE 23.1 ARE NOT PRACTICAL WHERE A CREDITOR IS PLAINTIFF

Although the demand requirement remains important where a creditor is the derivative plaintiff, Rule 23.1 is an inappropriate procedural mechanism for enforcing the requirement against creditor-plaintiffs. The heightened pleading requirements under Rule 23.1 "exist[] at the threshold" of the demand requirement for stockholders for two reasons: "first to ensure that a stockholder exhausts his intercorporate remedies, and then to provide a safeguard against strikesuits."[46] But, as discussed below, a creditor does not possess "intercorporate" remedies. Moreover, there are at least two practical problems with deploying Rule 23.1 against a creditor-plaintiff that render Rule 23.1 more of an impediment to legitimate actions than a necessary "safeguard" against strikesuits.

The first practical problem with applying Rule 23.1's heightened pleading standard to creditors is that creditors do not have the same tools for gathering sufficient pre-complaint information to satisfy the rule's requirements. The general

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45. *See id.* at 103 ("Directors of insolvent corporations must retain the freedom to engage in vigorous, good faith negotiations with individual creditors for the benefit of the corporation."); *cf.* Trenwick Am. Litig. Trust, 906 A.2d 168 at 174 (rejecting cause of action for "deepening insolvency").

46. *Aronson*, 473 A.2d at 811-12.

rule is that "derivative plaintiffs are not entitled to discovery in order to demonstrate demand futility."[47] Consequently, Delaware courts have repeatedly instructed would-be stockholder plaintiffs to use Section 220 of the DGCL as the primary means for discovering the "particularized" facts that they must plead to satisfy Rule 23.1.[48] "Section 220 provides shareholders of Delaware corporations with a qualified right to inspect corporate books and records."[49] Specifically, Section 220 provides that "[a]ny stockholder, in person or by attorney or other agent shall, upon written demand under oath stating the purpose thereof, have the right during the usual hours for business to inspect for any proper purpose…[t]he corporation's stock ledger, a list of its stockholders, and its other books and records."[50] As the plain language of the case law and Section 220 itself suggest, however, creditors have no right under Section 220.[51] Without a means for pre-suit discovery, creditors will more likely than not fall short of the demanding pleading requirements of Rule 23.1.

The second practical problem is that directors of an insolvent corporation may be overly reluctant to authorize suit where there is little cash to fund it or provide for indemnity, advancement, and insurance for the defendants.[52] At the same time, a conclusory allegation of such reluctance, by itself, would likely fall short of the particularity that Rule 23.1 would require to adequately allege that the directors are unable to exercise their independent business judgment as required by the *Aronson*/*Rales* tests. Ironically, application of a "particularity" requirement in this context makes the very condition that gave the creditor the right to sue derivatively—the corporation's insolvency—a shield for directors to prevent the creditor from exercising that right.

The third problem with applying Rule 23.1 and the *Aronson*/*Rales* tests to creditor derivative suits is theoretical: creditors did not elect the board they must confront, and have no extra-contractual power to vote in a new slate of directors.[53] As noted, one of the goals that the Delaware Supreme Court sought to achieve with the *Aronson* test is "to insure that a stockholder exhausts his intercorporate remedies."[54] This goal is inapplicable where a creditor sues on behalf of the corporation because "[w]hile shareholders rely on directors acting as fiduciaries to protect their interests," and retain the power to elect different directors if the current board is does not do so adequately, "creditors are afforded protection through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing,

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47. *See, e.g.*, *Beam*, 845 A.2d at 1056; *Levine v. Smith*, 591 A.2d 194, 209 (Del. 1991).

48. *See South*, 62 A.3d at 6 & n.1 (collecting cases); *see also, e.g.*, *Beam*, 845 A.2d at 1056 (dismissing derivative complaint for failure to plead sufficient facts to support her claim of demand futility and stating that "[b]oth this Court and the Court of Chancery have continually advised plaintiffs who seek to plead facts establishing demand futility that plaintiffs might successfully have used a Section 220 books and records inspection to uncover such facts.").

49. Melzer v. CNET Networks, Inc., 934 A.2d 912, 916-17 (Del. Ch. 2007).

50. 8 DEL. C. § 220.

51. *See id.* § 220(b) (allowing "any stockholder" to demand to inspect the corporation's books and records); *Prod. Res.*, 863 A.2d at 796 (noting "the absence of any right by creditors to seek books and records").

52. *See Prod. Res.*, 863 A.2d at 796 (recognizing that "directors might be extremely hesitant to granting a demand when the corporation's financial condition has weakened its ability to provide indemnification and insurance").

53. *See Prod. Res.*, 863 A.2d at 796.

54. *Aronson*, 473 A.2d at 811.

bankruptcy law, general commercial law and other sources of creditor rights."[55] The Delaware Supreme Court has held that these existing creditor rights are sufficient tools to allow creditors to protect their interests.[56] Thus, the *Aronson* court's observation that "a stockholder is not powerless to challenge director action which results in harm to the corporation"[57] stands in stark contrast to the position of an aggrieved creditor.

In short, Rule 23.1's particularized pleading requirement poses unfair and unfounded obstacles to a creditor's derivative suit. Delaware should consider a different test to implement the demand requirement for derivative creditor-plaintiffs.

V. THE *CYBERGENICS* TEST SHOULD BE USED TO DETERMINE DEMAND FUTILITY FOR CREDITORS SUING DERIVATIVELY UNDER *GHEEWALLA*.

Given the obstacles and issues outlined above, Delaware should develop a "procedural embodiment"[58] of the demand requirement for creditors suing derivatively that is more workable than Rule 23.1. Ideally, Delaware's General Assembly would enact a statute analogous to Rule 23.1 that would give creditor-plaintiffs clear guidance. Alternatively, the courts may establish a judicial rule of pleading demand futility applicable to creditor-plaintiffs, just as the Delaware Supreme Court set forth the test for pleading demand futility for stockholders in *Aronson*.[59] In either scenario, the rule need not be crafted in a vacuum. Bankruptcy courts in Delaware and elsewhere have been ably addressing creditors' requests for derivative standing to pursue causes of action belonging to a debtor corporation for years.

In 2003, the U.S. Court of Appeals for the Third Circuit approved the practice of granting derivative standing to creditors in *Official Committee of Unsecured Creditors of Cybergenics Corp. ex rel. Cybergenics Corp. v. Chinery*.[60] The *Cybergenics* line of cases requires a creditor to satisfy a three-part test before it may pursue the corporation's causes of action: (1) the creditor must allege "colorable" claims; (2) the creditor must show that the debtor "unjustifiably refused" to assert the claims; and (3) the creditor must affirmatively obtain a court order authorizing the creditor to pursue the claims.[61]

To state a "colorable" claim under *Cybergenics*, the creditor must plead facts that state a "plausible" claim for relief.[62] This test is familiar to federal bankruptcy courts, because it is "the same analysis as when a defendant moves to

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55. *Gheewalla*, 930 A.2d at 99.

56. *Id.*

57. *Aronson*, 473 A.2d at 811.

58. *Quadrant I*, 102 A.3d at 182 (quoting *Rales*, 634 A.2d at 932).

59. *Aronson*, 473 A.2d at 814.

60. 330 F.3d 548 (3d Cir. 2003).

61. *See id.* at 566-67; Infinity Investors Ltd. v. Kingsborough (In re Yes! Entm't Corp.), 316 B.R. 141, 145 (D. Del. 2004); In re Optim Energy, LLC, 2014 Bankr. LEXIS 2155, *17 (Bankr. D. Del. May 13, 2014), aff'd, Walnut Creek Mining Co. v. Cascade Inv., LLC (In re Optim Energy, LLC), 527 B.R. 169 (D. Del. 2015).

62. *See, e.g.*, *In re Optim Energy*, 2014 Bankr. LEXIS 2155, *18.

dismiss a complaint for failure to state a claim" under Federal Rule of Civil Procedure 12(b)(6).[63] The analysis has two steps: "'[f]irst, the factual and legal elements of a claim should be separated. The [trial court] must accept all of the complaint's well-pleaded facts as true, but may disregard any legal conclusions.'"[64] Second, the trial court then "determine[s] whether the facts alleged in the complaint are sufficient to show that the plaintiff has a plausible claim for relief."[65] A complaint should state a "colorable" claim if it alleges enough well-pleaded facts to create, in light of the court's "judicial experience and common sense,"[66] "a reasonable expectation that discovery will reveal evidence of the necessary element."[67]

Delaware trial courts may balk at applying a "plausibility" standard at a preliminary stage in litigation. The Delaware Supreme Court has repeatedly held that it is legal error under Delaware law to apply the federal "plausibility" standard to dismiss a complaint under Rule 12(b)(6).[68] In *Central Mortgage*, for example, the Delaware Supreme Court "emphasize[d] that, until this Court decides otherwise or a change is duly effected through the Civil Rules process, the governing pleading standard in Delaware to survive a motion to dismiss is reasonable 'conceivability'—that is, a Delaware trial court cannot dismiss a complaint "unless the plaintiff would not be entitled to recover under any reasonably conceivable set of circumstances."[69] The "conceivability" standard is a "minimal" one "more akin to possibility while the federal plausibility standard falls somewhere beyond mere possibility but short of probability."[70]

Delaware trial courts applying a *Cybergenics* analysis at the outset of a creditor-initiated derivative suit should be able to avoid the holding of *Central Mortgage*, however, because the purpose of applying a "plausibility" test in the *Cybergenics* context is not to judge the sufficiency of the complaint in response to a defendant's motion under Rule 12(b)(6). Rather, the court would be ruling whether the creditor has satisfied a standard that, akin to Rule 23.1, imposes a barrier to entry for creditors attempting to usurp the board's managerial authority. Requiring a creditor to allege a "plausible" claim at that stage in the procedure works a compromise between merely stating a "conceivable" claim and alleging the particularized facts required by Rule 23.1.[71] This compromise balances the competing interests of board authority and creditor access discussed above.

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63. *Id.*; *see also* Ashcroft v. Iqbal, 129 S. Ct. 1937, 1949 (2009) ("To survive a motion to dismiss, a complaint must contain sufficient factual matter, accepted as true, to state a claim to relief that is plausible on its face."); Bell Atl. Corp. v. Twombly, 550 U.S. 544, 556 (2007) (same).

64. *Walnut Creek Mining Co.*, 527 B.R. at 173-74 (quoting Fowler v. UPMC Shadyside, 578 F.3d 203, 210 (3d Cir. 2009)).

65. *Id.* at 174 (quoting *Fowler*, 578 F.3d at 210).

66. *See, e.g.*, *Fowler*, 578 F.3d at 211.

67. *Twombly*, 550 U.S. at 555-56.

68. *See* Cent. Mortg. Co. v. Morgan Stanley Mortg. Capital Holdings LLC, 27 A.3d 531, 535 (Del. 2011); *see also* Canbium Ltd. v. Trilantic Capital Partners III, L.P., Case No. 363, 2011 (Del. Jan. 20, 2012) (Order).

69. *Cent. Mortg.*, 27 A.3d at 535, 537; *Canbium Ltd.*, No. 363, 2011 (order).

70. *Cent. Mortg.*, 27 A.3d at 536, 537 & n.13.

71. *See Cent. Mortg.*, 27 A.3d at 537 n.13 ("[T]he federal plausibility standard falls somewhere beyond mere possibility but short of probability.").

To this end, a creditor's claim would only be "plausible"—and thus "colorable" for demand futility purposes—if the complaint contained well-pleaded facts that would "raise a reasonable expectation that discovery will reveal evidence"[72] of conduct that would strip directors of the protection of the business judgment rule. This "plausibility" standard also dovetails nicely with the stockholder-demand-futility test that asks whether the plaintiff has pleaded facts giving rise to a "substantial likelihood" that the proposed lawsuit would subject directors to personal liability.[73] Both standards require the court to make a substantive judgment on the merits, while giving the plaintiff the benefit of reasonable inferences.[74]

In addition to alleging a "colorable" claim, a creditor seeking to serve as a derivative plaintiff must convince the court that the board's refusal (or presumed refusal) to bring the action is "unjustifiable." It should be the creditor's burden at the threshold of the litigation to come forward with sufficient (but not particularized) information of "unjustifiable" refusal, taking into consideration that the creditor has not yet taken discovery. The inquiry will necessarily be fact specific, and the court should consider the context in which the challenged transaction arose, the conduct and affiliations of the directors, and any business rationale for refusing to bring the claim.[75] Again, this formulation mirrors the familiar duty of the Court of Chancery to gauge whether a stockholder plaintiff has created a reasonable doubt as to the board's ability to consider a demand "on a case by case basis, employing an objective analysis."[76] In both the solvent and insolvent contexts, the court will look closely at the facts and circumstances to determine whether the board could objectively consider a demand.

Only if the court initially concludes that the creditor-plaintiff has alleged a "plausible" claim and that the corporation has "unjustifiably" refused to bring the claim would the derivative complaint then proceed.[77] Adopting this rule would allow the court to serve the gatekeeper role envisioned by Rule 23.1. It maintains the board's managerial authority by deferring to the board's business judgment in the absence of a "colorable" claim for breach of fiduciary duty, but permits creditor-plaintiffs to enforce insolvent corporations' rights without meeting the rigorous and ill-fitting requirements of Rule 23.1.

Finally, applying the *Cybergenics* rule in Delaware state courts would also promote uniformity among different sets of laws. As Chief Justice Strine has observed, Delaware law is sparse in this because "in most situations involving insolvent public companies, the firm is placed in bankruptcy, and the procession of claims belonging to the firm is

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72. *Twombly*, 550 U.S. at 555-56.

73. *See Rales*, 634 A.2d at 936; *South*, 62 A.3d at 14; Seminaris v. Landa, 662 A.2d 1350 (Del. Ch. 1995); In re Baxter Int'l Inc. S'holders Litig., 654 A.2d 1268 (Del. Ch. 1995).

74. *See Cent. Mortg.*, 27 A.3d at 537 (stating that the "plausibility" standard "invites judges to…draw on…judicial experience and common sense."); *South*, 62 A.3d at 14.

75. *See, e.g.*, In re Yes! Entm't Corp., 316 B.R. at 145 (finding "unjustifiable" refusal where the creditor "only filed the Complaint when the statute of limitations was about to expire, and the Chapter 11 Trustee refused to act based on a lack of familiarity with the facts supporting the claims."); In re Std. Register Co., Case No. 15-10541, Tr. at 65:2-9 (Del. Bankr. D. Del. June 8, 2015) ("Case Law teaches that creditors have the right to look back at transfers and prepetition conduct and in the present circumstances the Debtor cannot be expected to vigorously consider and pursue these matters given the relative bargaining positions of the parties on a pre-bankruptcy basis.").

76. *See, e.g.*, Grobow v. Perot, 539 A.2d 180, 186 (Del. 1988).

77. *See In re Optim Energy*, 2014 Bankr. LEXIS 2155, at *35 (denying motion for creditor standing because creditor did not allege "colorable" claims).

addressed through the Bankruptcy Court process."[78] By adopting the *Cybergenics* standard, Delaware can draw upon the developed body of bankruptcy law and thereby provide creditor-plaintiffs with some degree of certainty, while at the same time retaining the necessary flexibility to rule upon the circumstances of the case, both of which are vital to Delaware's position in the world of corporate law.

VI. CONCLUSION

Derivative standing is an important tool for creditors, but one which must be wielded appropriately. Creditors seeking to enforce an insolvent corporation's rights should be required to first seek redress from the proper authority, the board of directors, before seizing control of a corporate claim. But in instances where making a demand upon the board would be futile, creditors should not be held to the same standards as shareholders, who by contrast to creditors have access to the corporation's books and records and are enfranchised to remove the directors. Rather, creditors should be able to pursue a corporate claim on behalf of the corporation so long as they can plead a "plausible" claim and convince the court at the outset of the litigation that the directors have "unjustifiably" refused to pursue the claim. This test balances the competing interests of the board and creditors, while allowing the Court of Chancery to serve as a gatekeeper against suits that, under the particular facts and circumstances, should remain under the board's control.

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78. *Prod. Res. Group*, 863 A.2d at 796.