

Shareholder Ruling Resolves Dual-Natured Claim Uncertainty

By **Robert May, Christina Ademola and Nitesh Daryanani**

(September 30, 2021, 5:10 PM EDT)

In a rare decision, the Delaware Supreme Court has overruled 15 years of precedent, eliminating the ambiguity surrounding so-called dual-natured direct and derivative claims.

Writing for a unanimous court in *Brookfield Asset Management Inc. v. Rosson*, Justice Karen Valihura held that a stockholder bringing a direct claim must demonstrate that they can prevail without showing injury to the corporation, and that claims that minority stockholders' economic and voting interests were improperly diluted, absent more, are exclusively derivative.[1]

The court's extensive analysis reckons with the muddy evolution of dual-natured claims since 2006, when the court's decision in *Gentile v. Rossette* created a route for minority stockholders to pursue direct dilution claims.[2]

Ultimately, the court reinstated its earlier, simpler formulation for differentiating between direct and derivative claims articulated in the 2004 *Tooley v. Donaldson Lufkin & Jenrette Inc.* decision, providing welcome clarity to corporate deal makers.[3]

Background

In 2006, the Delaware Supreme Court created tension in a significant area of Delaware corporate law with the *Gentile* decision, by holding that extraction or expropriation of economic value from the minority by a controlling stockholder constitutes direct injury.[4] Such claims had previously been deemed derivative claims, properly belonging to the corporation.[5]

The *Gentile* court's decision obfuscated the mandate handed down by the Delaware Supreme Court just two years earlier in *Tooley*. [6]

The *Tooley* court articulated a two-prong test to determine whether a stockholder's claim is direct or derivative, focused on:

1. Who suffered the alleged harm — the corporation or the stockholders,



Robert May



Christina Ademola



Nitesh Daryanani

individually; and

2. Who would receive the benefit of any recovery or other remedy — the corporation or the stockholders, individually.

Delaware courts have struggled with Gentile's application. In the 2016 case *El Paso Pipeline GP Co. v. Brinckerhoff*, the tension came to a head, when Chief Justice Leo Strine called Gentile "a confusing decision, which muddies the clarity of our law in an important context, ... [and] cannot be reconciled with the strong weight of our precedent."^[7]

In *El Paso*, Justice Strine recognized that Gentile "can be read as undercutting the traditional rule that dilution claims are classically derivative."^[8]

Against this backdrop, the decision in *Brookfield* further examined the problem and overruled *Gentile*.

Gentile Creates Confusion in Delaware Corporate Law

In *Gentile*, the Supreme Court considered an improper transfer of both economic value and voting power from the minority stockholders to the controlling stockholder. The court observed that there were two independent aspects of the plaintiffs' claims, namely, the overpayment claim and the minority's significant loss of cash value and voting power.^[9]

According to the court, unlike the typical overpayment transaction, this dual-natured claim included elements of a direct claim.^[10] The *Gentile* panel addressed the tension with *Tooley* by focusing on the identity of the alleged wrongdoer — the controlling stockholder — and the unique harm to the minority stockholders resulting from a breach of a fiduciary duty owed to them by the controlling stockholder.

The Delaware Court of Chancery has struggled to apply *Gentile*, resulting in inconsistent outcomes and uncertainty for corporate deal makers. At times, Delaware courts expanded *Gentile*'s reach beyond controlling stockholder situations.

The Chancery Court's 2013 *Carsanaro v. Bloodhound Technologies Inc.* decision held that self-interested stock issuances effectuated by a board lacking a disinterested and independent majority could be challenged by a direct claim.^[11]

A year later, the Chancery Court's *In re: Nine Systems Corp. Shareholders Litigation* decision extended *Gentile* to cover the self-interested actions of a group of stockholders acting as a functionally equivalent control group.^[12]

Brookfield Resolves the Tension

In 2019, *TerraForm Power Inc.* stockholders filed a derivative class action in the Chancery Court against the company's directors and its controlling stockholder, *Brookfield*, for breach of fiduciary duties.

In their pleadings, the stockholders challenged the issuance of *TerraForm* stock to *Brookfield* in a private placement for inadequate value, which in turn diluted both the financial and voting interests of the minority stockholders.

While the lawsuit was pending, *TerraForm* completed a merger with *Brookfield*, extinguishing the

derivative claims.[13]

Turning to the dilution claims, the Chancery Court recognized that, under Tooley, they were "the quintessence of a claim belonging to an entity: that fiduciaries, acting in a way that breaches their duties, have caused the entity to exchange assets at a loss." [14] The trial court further explained that even in the face of a controlling stockholder transaction, the plaintiffs' "overpayment claims neatly fall into the derivative category" espoused by Tooley. [15]

But recognizing the ambiguity created by Gentile, the Chancery Court continued its analysis and concluded that the minority stockholders stated a direct claim because "[t]he facts alleged in the Complaint fit Gentile's transactional paradigm to a T." [16] In reaching its conclusion, the Chancery Court acknowledged that the current doctrinal framework was unsatisfying. [17]

The Delaware Supreme Court accepted an interlocutory appeal and welcomed the opportunity to clarify the framework for analyzing dilution claims.

In its decision, the court acknowledged that classification of a particular claim as derivative or direct can be difficult. [18] But the court further noted the significance of a consistent and predictable framework because the determination as to whether a claim is derivative or direct is often "outcome-determinative" because a merger extinguishes derivative claims by eliminating minority stockholders' standing to pursue them. [19]

Applying the straightforward Tooley framework, the Supreme Court observed that the gravamen of the minority stockholders' claim was that the private placement was unfair and that TerraForm suffered harm as a result.

The dilution in the value of the corporation's stock was the unavoidable result of the reduction in the value of the entire corporate entity. The economic and voting power dilution that allegedly harmed the stockholders flowed indirectly to them in proportion to, and via, their shares in TerraForm, and thus any remedy should flow to them the same way, derivatively via the corporation.

The Supreme Court also rejected the notion that controlling stockholder transactions yielded different outcomes. In rejecting this focus on the alleged wrongdoer, the court returned the focus to the crux of the Tooley analysis — namely "who suffered the harm and who would receive the benefit." [20]

The Supreme Court concluded that there is "no principled reason to allow dilution/overpayment claims to proceed directly against controllers when the law rightly refuses to permit such claims to proceed directly in non-controller dilution cases." [21]

Conclusion

The Brookfield decision removes a 15-year tension in the direct-derivative doctrine, clearing a path for greater certainty for corporate deal makers. The key question to identify a direct claim is whether the stockholder has demonstrated that they have suffered an injury that is not dependent on an injury to the corporation.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] Del. Supr., _ A.2d _, No. C.A. No. 406, 2020 (September 20, 2021), available here.
[link: <https://courts.delaware.gov/Opinions/Download.aspx?id=324500>].

[2] Gentile v. Rossette, 906 A.2d 91 (Del. 2006).

[3] Tooley v. Donaldson Lufkin & Jenrette Inc., 845 A.2d 1031 (Del. 2004).

[4] Gentile v. Rossette, 906 A.2d 91 (Del. 2006).

[5] See, e.g., Oliver v. Bos. Univ., 2006 WL 1064169, at *17 (Del. Ch. Apr. 14, 2006); Green v. Locate Plus Holdings Corp., 2009 WL 1478553, at *2 (Del. Ch. May 15, 2009).

[6] Tooley v. Donaldson Lufkin & Jenrette Inc., 845 A.2d 1031 (Del. 2004).

[7] El Paso Pipeline GP Co. LLC v. Brinckerhoff, 152 A.3d 1248, 1265-66 (Del. 2016).

[8] Id. at 1251.

[9] Gentile, 906 A.2d at 99.

[10] Id. at 100 n. 21.

[11] Carsanaro v. Bloodhound Technologies, Inc., 65 A.3d 618, 658 (Del. Ch. 2013).

[12] In re Nine Sys. Corporation Shareholders Litig., 2014 Del. Ch. LEXIS 171 (Ch. Sep. 4, 2014); 2014 WL 4383127, at *26 (Del. Ch. Sept. 4, 2014).

[13] In re TerraForm Power Inc. S'holders Litig., Civ. A. No. 2020-0050-SG, Stip. and Order of Partial Dismissal, Dkt. No. 80.

[14] TerraForm Power, 2020 WL 6375859, at *9 (Del. Ch. Oct. 30, 2020).

[15] Id. at *11.

[16] Id. at *12.

[17] Id. at *15.

[18] Brookfield, No. 406, at 18-19.

[19] Id. at 19.

[20] Id. at 39.

[21] Id. at 40.