

Second Circuit Seeks Guidance from Delaware on Direct Shareholder Lawsuits for Holding Stock Based on Alleged Misstatements

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May former stockholders who allege they were damaged by holding stock of a company, because of fraudulent and negligent misrepresentations about the company's financial status, sue the company directly versus in a derivative action on behalf of the corporation? The Delaware Supreme Court may soon settle this issue. Imagine this scenario. You are an in-house counsel for a large company and receive a complaint from a high-net worth couple (and their various entities and trusts) that used to own a large minority of shares (more than 17 million) of your company's common stock. The complaint alleges that in 2007 the couple began implementing a plan to sell this stock and sold 1 million of those shares at about \$55 per share. Thereafter, the couple purportedly delayed further sales of stock when the company's stock price began declining likely based on the onset of the subprime mortgage crisis. The former stockholders assert that they held onto the stock because they believed, based on the company's public and private representations to them, that the company was

in a better financial position than other companies were and would recover from the downturn. However, in the next 16 months the stock price fell precipitously to about \$3 per share. It was not until that time that the couple finally sold – purportedly after having lost all faith in the truthfulness of the company’s disclosures about its financial performance and the riskiness of its investments. The couple now claims damages of more than \$800 million alleging that if they had received truthful and accurate information from the company in 2007 about its true risk posture, they would have sold then, when the stock was priced at more than \$50, instead of at the \$3 they ultimately received. The couple no longer owns any stock of the company, so they have brought a direct action for individual compensatory damages. Under Delaware law, should this case be quickly dismissed for lack of standing by these non-stockholders, or have these plaintiffs alleged an injury that allows them to bring a direct claim? Under current Delaware law, as the Second Circuit recently contemplated, the answer may not be that straightforward. In *AHW Investment Partnerships, MFS, INC., et al v. Citigroup, Inc., et al*, decided on November 25, 2015, the Second Circuit Court struggled with the question of standing under these facts. Stumped over whether such a claim was direct or derivative, the court certified the following question to the Delaware Supreme Court as one of “great public importance” under 2d Cir. Local R. 27.2(a) and Del. Sup Ct. R. 41(a)(ii).

Are the claims of a plaintiff against a corporate defendant alleging damages based on the plaintiff’s continuing to hold the corporation’s stock in reliance on the defendant’s misstatement as the stock diminished in value properly brought as direct or derivative claims?

The eventual answer to this question will undoubtedly turn on an analysis of *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, 845 A.2d 1031 (Del. 2004) and its progeny. In *Tooley*, the Delaware Supreme Court stated that it was definitively determining when a stockholder’s claim should be classified as derivative or direct. The court held that the:

issue must turn *solely* on the following questions: (1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?

Id. at 1033. The court expressly disapproved the concept of “special injury” to the plaintiff, which had been used by previous courts in the analysis of whether a plaintiff could bring a direct claim. The court directed that it was the “nature” of the wrong and to “whom” the relief would flow (the corporation or individual) that determined the type of claim. But the court also stated that the stockholder’s “claimed direct injury must be independent of any alleged injury to the corporation.” *Id.* at 1035; 1039. While the *Tooley* decision has been uniformly cited by Delaware courts as the foundational law in making a direct-versus-derivative standing determination, the actual application of the *Tooley* questions by subsequent courts has left much unsettled, with some courts seemingly returning to a “special injury” test based on the *Tooley* court’s language regarding the “independence” of the alleged injury. For example, in *Gentile v. Rossette*, 906 A.2d 91 (Del. 2006),

with three of the same justices from the *Tooley* court, the Delaware Supreme Court muddied its prior emphatic disapproval of a “special injury” inquiry. The *Gentile* court allowed a direct claim for breach of fiduciary duties from minority shareholders arising out of debt conversion that affected minority voting power, following a merger, holding that the harm was “unique” to the shareholder and “independent” of any injury to the corporation. The court agreed that stock dilution claims that impact the voting rights of a shareholder can be brought directly, while simple dilution of stock claims cannot. The court reasoned that the dilution in value of the corporate stock affects “equal” injury to all shares and is not injury to specific shareholders. The court also recognized that there can be claims that have *both* a direct and derivative component, such as where the corporation is harmed by overpayment to a controlling shareholder and the minority shareholders are individually harmed by a change in their voting power. Two years later, in *Feldman v. Cutaia*, 951 A.2d 727 (Del. 2008), with two of the same justices as in *Gentile* and three of the same as in *Tooley*, the court seemed to return again to the concept of “special injury.” In *Feldman*, a former stockholder sued the corporation directly alleging that he received inadequate payment from a merger that cashed out his stocks. The court held that he did not have standing to bring his breach of fiduciary duty claim directly because he had no *individualized* harm “not suffered by all of the stockholders at large.” *Id.* at 733. “The mere fact that the alleged harm is ultimately suffered by, or the recovery would ultimately inure to the benefit of, the stockholder does not make a claim direct under *Tooley*...” *Id.* The Second Circuit in *AHW Investment* wrestled with harmonizing these seemingly conflicting Delaware Supreme Court decisions – *Tooley* on the one hand, and *Gentile* and *Feldman* on the other – as to whether a “special injury” requirement was still applicable. The Second Circuit also looked at additional lower court and Second Circuit decisions on this issue including Second Circuit cases expressly finding that claims surrounding inducement to *hold* stock could not be brought directly while inducement to *buy or sell* stock claims could be brought directly. From this posture the Second Circuit ultimately certified the above question to the Delaware Supreme Court for clarification. Whether the Delaware Supreme Court will simply answer the question posed for “holder” direct claims or include a broader discussion and clarification of *Tooley* and its progeny remains to be seen. From the Second Circuit’s discussion, it appears that broader guidance would assist courts on the applicability of or differences in the “special injury” versus “independent injury” question. Either way, the final decision will have an influence on shareholder lawsuits, including possible expansion of direct stockholder claims to include inducement to retain stock. *Image source: Famartin (Wikimedia)*

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