

# Direct or derivative claims: Is 'Brookfield' the end or just the beginning?

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A Delaware corporation's stockholder may bring an individual action to address unique injuries specific to his or her legal rights as a stockholder (a direct claim) or a suit on behalf of the corporation for harm done to the corporation (a derivative claim).

Despite this deceitfully unassuming threshold standing criterion, Delaware courts have often struggled to decipher what constituted a direct or derivative claim. The Delaware Supreme Court's 2021 decision in *Brookfield Asset Mgmt., Inc. v. Rosson* helped clarify whether stockholders' financial and voting rights, diluted through a transaction with a controlling stockholder, constituted direct or derivative claims.

## Tooley test and Gentile's carve-out

Prior to *Brookfield*, in 2004, the Delaware Supreme Court had announced a simplified test in *Tooley v. Donaldson, Lufkin & Jenrette, Inc.* to determine whether claims were direct or derivative, which centered on two 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)?"

*Tooley's* test tracked the rationale in the Court's 1988 decision in *Kramer v. W. Pac. Indus., Inc.* that "a court should look to the nature of the wrong and to whom the relief should go." Two years later, however, the Court in 2006 provided a carve-out to *Tooley* in *Gentile v. Rossette*.

Relying on *In re Tri-Star Pictures, Inc., Litig.*, the *Gentile* Court held that a stockholder, who allegedly suffered diluted economic and voting rights as a result of a transaction involving a controlling stockholder, had standing to pursue direct claims because such dilution/overpayment claims were "dual natured" (i.e., both direct and derivative).

Though all stockholders shared derivatively in the economic harm, the loss of voting rights constituted a unique harm suffered by the stockholders directly. Because of *Gentile's* holding, this dual natured exception created palpable tension between it, *Tooley*, and their progeny — often proving difficult to apply — until *Brookfield* was decided 15 years later.

## Delaware Supreme Court's decision in *Brookfield*

In *Brookfield*, stockholders challenged a company's private placement of stock to its controlling stockholder because the transaction allegedly diluted both the financial and voting interests of the minority stockholders. After the stockholders filed their complaint, the controlling stockholder acquired the company's remaining shares in a merger.

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The defendants moved to dismiss, arguing that dilution claims were "entirely derivative" under the *Tooley* test and that the stockholders lacked standing to bring derivative claims after a merger. Although the Court of Chancery agreed that the stockholders' dilution/overpayment claims were derivative under *Tooley*, it denied the motion to dismiss because the stockholders stated a direct claim under *Gentile's* exception.

On interlocutory appeal, the defendants/appellants renewed their argument that the stockholders' claims were derivative under *Tooley* and contended that *Gentile* should be overruled. The Delaware Supreme Court ultimately agreed and reversed the Court of Chancery's decision, holding that "the corporation overpayment/dilution *Gentile* claims ... are exclusively derivative under *Tooley* and that *Gentile* ... should be overruled." The Court noted that the tension between *Gentile* and *Tooley*, *Gentile's* superfluous "carve-out" given *Revlon, Inc. v. MacAndrews & Forbes Hldgs., Inc.*, and the potential for double-recovery under *Gentile* warranted overruling it.

## Nuances of *Brookfield*

The Court's decision in *Brookfield* brought much needed clarity to the application of *Tooley*, both generally and to overpayment/dilution claims in particular, and helped reconcile two divergent lines of cases, *Tri-State* and *Kramer*, by overruling the Court's prior decision in *Gentile*. Yet, this newfound clarity opened the door to nuances that *Brookfield* did not address, particularly as to claims that do not neatly fit as dilution/overpayment claims.

*Brookfield also left open the possibility that dilution claims could still be considered direct claims under a Revlon analysis.*

Courts have begun to grapple with these nuances by focusing their analysis through *Brookfield's* lens. This year, for instance, in *In re MultiPlan Corp. S'holders Litig.* (2022), the Court dealt with whether to characterize SPAC shareholders' redemption rights claim as direct or derivative on a motion to dismiss. Citing *Brookfield*, the Court distinguished the redemption rights claim from a typical overpayment/dilution case because the harm — impairing stockholders' ability to exercise their redemption rights — and the resulting damages would run to the stockholders, not the company. As a result, the Court held that the redemption rights claim was direct.

*Brookfield* also left open the possibility that dilution claims could still be considered direct claims under a *Revlon* analysis. *Revlon*, another bedrock Delaware case from 1986, provided that enhanced scrutiny applied to board decisions in three scenarios, as summarized by the Delaware Supreme Court's decision in *Paramount Commc'ns, Inc. v. QVC Network, Inc.* (1994): (1) "when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear break-up of the company"; (2) "where, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction involving the break-up of the company"; or (3) when approval of a transaction results in a "sale or change of control."

Before *Brookfield*, the Court, when determining whether a claim was direct or derivative, noted in *El Paso Pipeline GP Co., L.L.C. v. Brinckerhoff* (2016) that "*Revlon* already accords a direct claim to stockholders when a transaction shifts control of a company from a

diversified investor base to a single controlling stockholder." Picking up on *Brinckerhoff's* reference, the *Brookfield* Court specifically called out this third *Revlon* scenario to address harm that would be considered uniquely felt by stockholders who lost control through dilution.

In overruling *Gentile*, the Court provided that there was "no practical need for the *Gentile* carve-out" because "[o]ther legal theories, e.g., *Revlon*, provide a basis for a direct claim for stockholders to address fiduciary violations in a change of control context." This was particularly true "when a transaction shift[ed] control of a company [from] a diversified investor base to a single controlling stockholder." Thus, these types of *Revlon* claims appeared to remain direct claims under *Brookfield*.

Recently, the Court of Chancery has picked up on the invitation to review alleged dilution claims under the *Revlon* framework. In *KZ Cap. Gen. Trading LLC v. Petrossov* (2022), a plaintiff stockholder brought, among other things, a direct claim for "economic and voting power dilution" against the director defendants premised on their allegedly misleading disclosures surrounding an outsider's investment in the company. The *KZ Cap.* Court, in denying defendants' motion to dismiss, found, in the circumstances present there, the plaintiff had stated a direct claim under *Revlon* by pleading sufficient facts creating a reasonable inference that the disputed transaction shifted control from a diversified group to a single stockholder.

## Takeaway

Although *Brookfield* is still in its infancy, the ripple effects have already begun to take root in Delaware law. Only time will tell how the courts will apply and interpret *Brookfield* when determining future creative claims seeking direct damages. Yet, if *MultiPlan* and *KZ Cap.* are any indication of things to come, *Brookfield* appears to have provided the courts with enough general guidance to make appropriate determinations on these issues thus far.

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