Today's
GENERAL COUNSEL

WINTER 2019 TODAY'S GENERAL COUNSEL

Compliance

Direct Versus Derivative in Shareholder Litigation

Is It an Ad Hoc Inquiry?

By Jon Polenberg

Whenever a shareholder brings a claim involving the company's officers and directors, the court must decide whether the shareholder is suing for harm suffered individually, and the claim is direct — or if the alleged harm is suffered by the company, and the claim is derivative. Distinguishing between direct and derivative claims, however, has become complicated. The following analysis is instructive for all jurisdictions, as most courts follow similar reasoning.

In 2004, the Delaware Supreme Court attempted to clarify the distinction between derivative and direct claims in *Tooley v. Donaldson, Lufkin & Jenrette, Inc.* The *Tooley* court examined three cases — *Kramer v. W. Pac. Indus., Inc.*, *Grimes v. Donald* and *Parnes v. Bally Entm't Corp.*

It first evaluated who had suffered the injury in *Kramer* because, in its words, "the stockholder must allege something other than an injury resulting from a wrong to the corporation." When the claim arises from mismanaging corporate assets, as in *Kramer*, it is determined to be derivative.

The *Tooley* court then addressed *Grimes*, reasoning that after evaluating the nature of the claim, the decision is based on whether the shareholder is seeking to recover damages for injury to the corporation. If not, then the claim is direct. Next, the *Tooley* court examined *Parnes*. It found that the injury claimed by the shareholder must be independent from the injury suffered by the corporation.

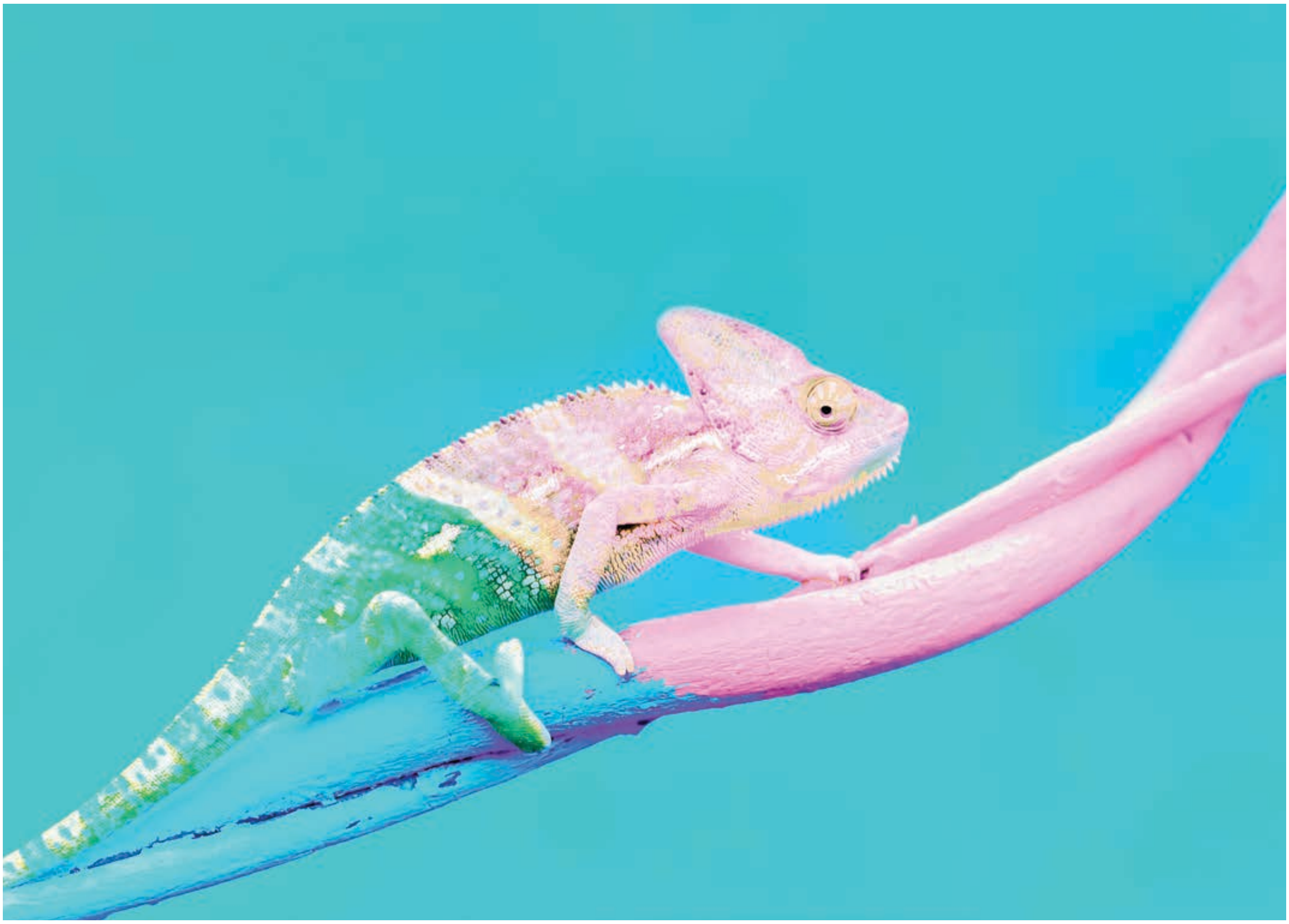
At its core, the standard involves two questions that determine whether claims are direct or derivative: (1) Who suffered the alleged harm — the corporation or the individual shareholder bringing the suit? and (2) Who receives the benefit from any recovery or other remedy — the corporation or the individual shareholder?

THE STANDARD APPLIED

This standard was central to the 2017 decision reached in *In re Straight Path Communications Inc. Consolidated Stockholder Litigation*, holding that a shareholder's post-merger claim was direct despite that the plaintiff shareholder would recover pro rata in proportion to the ownership in the corporation's stock — what would otherwise appear to be a derivative claim. It is important to note that the direct/derivative distinction for post-merger claims carries greater significance because, after a merger, shareholders lose standing to pursue derivative claims once they are no longer shareholders. Hence, if the claim is derivative, the post-merger lawsuit ends.

In the merger context, the *Parnes* court stated, "A stockholder who directly attacks the fairness or validity of a merger alleges an injury to the stockholders, not the corporation, and may pursue such a claim even after the merger at issue has been consummated." To maintain a direct claim, therefore, a shareholder must challenge the merger's validity. The merger standard as applied here distinguishes between challenges to the merger itself and challenges to alleged wrongs associated with the merger. The standard seems to have departed from evaluating who suffers the harm and benefits from the remedy.

> The *Straight Path* court decided that the alleged facts support a reasonable inference that the controlling shareholder improperly diverted merger proceeds that otherwise would have gone to the shareholders.



In the *Parnes* case, the CEO notified potential buyers that his consent was necessary for any transaction, and the price for that consent was money and assets from the company. Several potential buyers declined; they believed it was illegal for the CEO to require payment for his consent. But one buyer ceded to the CEO's demands. After the parties consummated the merger, shareholders challenged it, and the Delaware Supreme Court held that the claims alleged were direct because the shareholder challenged the process's fairness and the price obtained in the merger.

The *Parnes* analysis exposed a subtle distinction with *Kramer.* In *Kramer*, the shareholder alleged that two directors breached their fiduciary duty by diverting money from the merger proceeds into stock options and golden parachutes, as well as extracting excessive or unnecessary fees and expenses for work performed to consummate the merger. The Kramer shareholder did not allege that the directors' favorable transactions made the merger price unfair or tainted the sales process. Although the shareholder alleged that the challenged transactions reduced the amount paid for the shares, the allegations amounted to claiming that the directors mismanaged the corporation, resulting in wasting assets. The claim in *Kramer* was thus derivative.

SUBSTANTIVE BASIS FOR EVALUATION

Consideration of the *Parnes* decision distinguished *Kramer,* based on the particular facts of the case. In *Golaine v. Edwards,* the Delaware Chancery Court has attempted to synthesize those two cases into a substantive basis for evaluating whether a claim is derivative. Under *Parnes*, the question is whether the shareholder has alleged that the purported side transactions caused harm by diverting money to an officer or director. In a rather formulaic way, *Golaine* interpreted *Parnes* to mean that the shareholder must allege facts showing any side payment that diverted merger proceeds would, if the directors or officers had acted properly, result in additional money for the shareholder. The analysis has thus shifted from examining the harm to an individual shareholder to shareholders as a group.

Straight Path involved a complicated merger after the company had entered into a Consent Decree that required it (1) to forfeit 20 percent of its licenses, (2) sell its remaining licenses within one year and (3) give up 20 percent of the sales proceeds to the government when the company was sold. The licenses, for the most part, constituted Straight Path's assets. Straight Path also held a right to indemnity from another entity, IDT. The indemnity right enabled Straight Path to recover, among other things, the 20 percent it would pay the government after completing a sale.

Both Straight Path and IDT had in common at least one shareholder, and he held a controlling interest in both entities. The challenge to finding a buyer was the need to address the indemnity claim against IDT, and how to assign and value that claim. To sell Straight Path, the shareholders decided they would preserve the indemnity claim for themselves or else they would lose one fifth of the merger proceeds after paying the government.

Recognizing the financial consequences, Straight Path approved creation of a litigation trust into which it would transfer the indemnity claim so that, after the merger, the trust could pursue IDT. From the merger, Straight Path shareholders would receive the merger proceeds and an interest in the trust proportionate to each shareholders' interest in Straight Path. The controlling shareholder for Straight Path and IDT therefore had a lot to lose when the trust sued IDT, and used his voting leverage to force the company to settle IDT's indemnity obligations below fair value.

The Delaware Chancery Court decided that the alleged facts support a reasonable inference that the controlling shareholder improperly diverted merger proceeds that otherwise would have gone to the shareholders. Specifically, the shareholders would not receive the benefit of the transaction structured to provide for the merger proceeds, minus the 20 percent penalty paid to the government, which was recoverable under the indemnity claim against IDT. Instead, the controlling shareholder benefitted from the forgiven debt owed by IDT, manipulating the merger process to secure benefits for IDT and himself at Straight Path's expense.

The *Straight Path* court reasoned that the alleged claims did not involve pre-merger talks in which a company's fiduciaries had made poor business decisions, reducing the merger consideration paid to the shareholder. Therefore, the controlling shareholder procured side benefits from the sales process directly related to the merger. The claims alleged were thus direct, not derivative.

> The courts seem to find the alleged claims are derivative when the person who owed the duty breached it from the seller's side of the transaction.

But the concern with the reasoning employed in *Straight Path* is that the analysis evaluates the duty owed by the controlling shareholder to other shareholders. The duty inquiry thus begs the question: Would the claim be derivative if Straight Path and IDT shared no common equity interests? The answer is probably yes. IDT could have still attempted to negotiate the indemnity claim pre-merger to mitigate its future risks. Straight Path could have made its decision to settle the indemnity claims, and scrutiny for the decision would likely turn on whether the decision met the business judgment rule. However, the court could have decided that the claim was derivative because the actions alleged reduced the amount Straight Path shareholders received from the merger voted on by all shareholders.

The direct/derivative analysis does not ordinarily evaluate the nature of the duties allegedly breached. The analysis has instead focused on who suffered the harm, and who benefits from the recovery. Asking those questions in *Straight Path* shows that the shareholders suffered the alleged harm collectively and would all benefit from the recovery in proportion to their pro rata share in the equity. Such allegations amount to a derivative claim.

But in *Parnes*, *Kramer*, *Golaine*, and *Straight Path*, the courts direct/derivative analysis examined the alleged facts regarding the purported wrongful conduct. For example, the courts seem to find the alleged claims are derivative when the person who owed the duty breached it from the seller's side of the transaction (i.e., charging excessive fees to the company, securing beneficial post-merger compensation and benefits).

On the other hand, the courts seem to find that the claims are direct when the alleged wrongful conduct affected the way the buyer structured the transaction, or when the transaction involved third parties who injected themselves into it to extract money or property (i.e., carving out money and assets from the merger transaction in favor of the officer or director, forcing a third-party settlement in order to consummate the merger).

The evolving standard therefore may spiral into an ad hoc inquiry deciding whether the alleged facts insult the conscience rather than evaluating who suffered the alleged harm and the effect of the remedy. The inquiry should be tied to deciding whether the harm and recovery affect a single shareholder (a direct claim) rather than affecting all shareholders in proportion to their respective ownership (a derivative claim). ■

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