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Delaware's Evolving Equity Dilution Standing Rules

BY TIMOTHY R. DUDDERAR AND JUSTIN MORSE

In a recent decision from the Delaware Court of Chancery, Vice Chancellor J. Travis Laster provided what seems to be an important step towards reconciling two strands of Delaware law, addressing the distinction between direct and derivative claims, that have been in subtle conflict for years. That decision, *Carsanaro v. Bloodhound Technologies, Inc.*,[1] has already been recognized as an important development in the law governing the relationship between company founders and venture capitalists.[2] The Vice Chancellor held that cashed-out stockholders had standing to bring direct, as opposed to derivative, claims alleging that a group of venture capital funds with majority representation on the Board inequitably diluted plaintiffs' equity stake before ultimately selling the company. In addition to expanding the breadth of stockholder rights to bring direct actions, *Carsanaro* is notable as an apparent step toward reconciling the accepted test under Delaware law for distinguishing between direct and derivative claims with one line of cases that has stubbornly stood outside of its ambit. It bears emphasis, however, that *Carsanaro* is only one step towards such reconciliation, and it remains to be seen whether Delaware law will continue down its path.

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Tooley and Development of the Delaware Standard

The standards for distinguishing derivative from direct claims under Delaware law were substantially clarified in the Delaware Supreme Court's 2004 decision in *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*[3] Prior to *Tooley*, there existed ''no standard test . . . applied in all cases to determine whether a given claim is derivative or direct.''[4] Frequently, however, Delaware courts in the pre-*Tooley* era applied the so-called ''special injury'' test, according to which a plaintiff could only bring direct claims if it suffered a ''special injury,'' defined as ''a wrong suffered by plaintiff that was not

[1] C.A. No. 7301-VCL, 2013 BL 69339 (Del. Ch. Mar. 15, 2013).

[2] *See, e.g.*, Bloomberg BNA, *Venture Capitalists Must Answer Shareholder Claims of Dilution*, 28 CORPORATE COUNSEL WEEKLY 89, 92 (2013).

[3] 845 A.2d 1031 (Del. 2004).

[4] *In re Paxson Communication Corp. Shareholders Litigation*, C.A. No. 17568, 2001 BL 951 (Del. Ch. July 10, 2001).

suffered by all stockholders generally or . . . [a] wrong [that] involves a contractual right of the stockholders, such as the right to vote.''[5] In *Tooley*, the Delaware Supreme Court disapproved of the special injury test, together with the related ''concept that a claim is necessarily derivative if it affects all stockholders equally.''[6] Rather than looking to whether a plaintiff could plead a special injury, the Delaware Supreme Court in *Tooley* ruled that the classification of claims as direct or derivative ''must turn *solely* on the following questions: (1) who suffered the alleged harm. . .; and (2) who would receive the benefit of any recovery or other remedy. . . .''[7]

Gentile v. Rossette and the Lingering Application of the 'Special Injury' Test

Although simple on its face, the two-part *Tooley* test has not brought a complete end to uncertainty, and close calls on the direct/derivative distinction continue to arise. In 2006, the Delaware Supreme Court provided some clarification in *Gentile v. Rossette*,[8] which involved allegations that defendants inequitably diluted – or, in the terminology adopted by *Gentile*, transferred or expropriated – stockholders' economic interest and voting power when a chief executive officer and controlling stockholder received stock from the corporation in exchange for forgiving debts of allegedly lesser value.[9] In *Gentile*, the Delaware Supreme Court ruled that, under certain circumstances, claims for dilution or expropriation may be brought either directly or derivatively. Specifically, the *Gentile* court held that either type of action may be brought where:

> (1) a stockholder having majority or effective control causes the corporation to issue 'excessive' shares of its stock in exchange for assets of the controlling stockholder that have a lesser value; and (2) the exchange causes an increase in the percentage of the outstanding shares owned by the controlling stockholder, and a corresponding decrease in the share percentage owned by the public (minority) shareholders.[10]

In arriving at its decision, the court cited and applied *Tooley*, which it had issued just two years before. Yet, while acknowledging that *Tooley* provided the exclusive test for determining whether a claim is derivative or direct, the Delaware Supreme Court also appears to have been influenced by pre-*Tooley* authority that *Tooley* itself criticized. First, the Delaware Supreme Court noted in its analysis that claims for ''corporate overpayment'' (a category it characterized as including expropriation) are typically treated as ''exclusively derivative.''[11] In describing the justification for viewing dilution claims as derivative and, importantly, in affirming that such a classification comports with *Tooley*, the Delaware Supreme Court stated in terms reminiscent of the special injury test:

> any dilution in value of the corporation's stock is merely the unavoidable result (from an accounting standpoint) of the reduction in the value of the entire corporate entity, of which each share of equity represents an equal fraction. **In the eyes of the law, such equal ''injury'' to the shares resulting from a corporate overpayment is not viewed as, or equated with, harm to specific shareholders individually.**[12]

Similarly, in explaining why claims involving expropriation undertaken specifically by a controlling stockholder may be brought directly, the Delaware Supreme Court explained that under such conditions, ''the public shareholders are harmed, uniquely and individually, to the same extent that the controlling shareholder is (correspondingly) benefited.''[13] Such statements appear to be indistinguishable from ''the concept that a claim is necessarily derivative if it affects all stockholders equally,''[14] of which *Tooley* disapproved. Despite never using the term ''special injury,'' then, *Gentile* relied on the core assumption of the special injury test: that a stockholder may bring a direct action where it is harmed by being treated differently from other stockholders. Thus, it appears that *Gentile*, likely not intentionally, re-introduced the concept of special injury, at least with respect to a (potentially limited) subset of wrongful dilution claims.

The influence of the special injury test, or at least the reasoning behind it, is also apparent from decisions cited by the *Gentile* court to justify direct standing, each of which was decided before *Tooley*, and, more importantly, relied on the special injury test. Although the Delaware Supreme Court most directly relied on *Turner v. Bernstein*,[15] that decision derived its relevant conclusions from another case also cited in *Gentile*: *In re Tri-Star Pictures, Inc*.[16] *Tri-Star*, in turn, involved challenges by former stockholders of Tri-Star Pictures, Inc. to transactions through which the Coca-Cola Company exchanged overvalued assets for Tri-Star stock, with the result that Coca-Cola obtained a majority position while the percentage owned by the minority correspondingly decreased. The Delaware Supreme Court in *Tri-Star* described application of the special injury test as ''well settled,'' and held based on that test that plaintiffs could bring direct claims because they had suffered harms stemming from loss of economic interest and voting power not suffered by Coca-Cola.[17]

Although *Tri-Star* relied on the special injury test, and although *Tooley* disapproved of that test in the period between *Tri-Star* and *Gentile*, the Delaware Supreme Court's holding in *Tri-Star* can be traced directly forward in time to *Gentile*. Notably, *Gentile* summarized *Tri-Star* in a way that did not include the words ''special injury'' but nevertheless preserved the reasoning of that test:

> This Court held that because Coca-Cola, as Tri-Star's largest stockholder, did not suffer a dilution of cash value, of voting power, or of ownership percentage to the same ex-

[5] *In re Tri–Star Pictures, Inc., Litig.*, 634 A.2d 319, 330 (Del. 1993).
[6] 845 A.2d at 1039.
[7] *Id.* at 1033.
[8] 906 A.2d 91 (Del. 2006).
[9] *Id.* at 93, 100.
[10] *Id.* at 100 (citing *Turner v. Bernstein*, C.A. No. 16190 (Del. Ch. Feb. 9. 1999); *In re Paxson*, 2001 BL 951; *Oliver v. Boston University*, C.A., No. 16570, 2000 BL 575 (Del. Ch. July 18, 2000)).
[11] 906 A.2d at 100.
[12] *Id.* at 99 (emphasis added).
[13] *Id.* at 100.
[14] *Tooley v. Donaldson, Lufkin & Jenrette Inc.*, 845 A.2d 1031, 1039 (Del. 2004).
[15] C.A. No. 16190 (Del. Ch. Feb. 9, 1999).
[16] 634 A.2d 319 (Del. 1993).
[17] *Id.* at 332.

> tent and in the same proportion as the minority shareholders, the **plaintiffs had suffered an injury that was unique to them individually** and that could be remedied in a direct claim . . . .[18]

In the years since *Gentile* was decided, the special injury test (in concept but not by name) has found its way into a number of decisions through reliance on *Gentile*. *Feldman v. Cutaia*,[19] an opinion discussed in *Carsanaro*, provides one example.[20] In *Feldman*, the Court of Chancery cited *Gentile*, along with another pre-*Tooley* case that applied special injury, to conclude that a claim cannot be direct where the alleged injury ''falls upon all shareholders equally and falls only upon the individual shareholder in relation to his proportionate share of stock as a result of the direct injury being done to the corporation.''[21] Like the Delaware Supreme Court in *Gentile*, the Court of Chancery in *Feldman* expressed this reasoning in terms of the *Tooley* analysis, but did not acknowledge its similarity to or the apparent substantial influence of the special injury test. Instead, *Feldman* seems to have been guided by *stare decisis* to find an interpretation of *Gentile* that would not ''swallow the general rule that equity dilution claims are solely derivative.''[22]

Carsanaro Begins Reconciliation

As the foregoing suggests, *Carsanaro* arose against a background of deceptively unsettled law. Plaintiffs were a group of former common stockholders of defendant Bloodhound Technologies, Inc. (''Bloodhound,'' or the ''Company''). Plaintiffs primarily alleged that, following successful rounds of financing, venture capitalists gained control of the Company's board and thereafter caused the Company to enter into a series of additional financings that involved only the venture capital firms (or their board representatives personally) as investors and were highly dilutive to plaintiffs' collective ownership percentage. Plaintiffs alleged that these financings were concealed from them and it was not until after Bloodhound was sold that plaintiffs discovered that their overall equity ownership had been drastically reduced. Through the lawsuit, plaintiffs sought a greater share of the proceeds from the sale, which they alleged they should have received but for the defendants' wrongful dilution of their equity ownership.[23]

Defendants moved for dismissal, arguing, among other things, that the fiduciary duty claims relating to the alleged dilution were derivative in nature and that the merger extinguished plaintiffs' standing to pursue them.[24] The Court of Chancery began its analysis with the *Tooley* test. Under that analysis, the Court of Chancery found that dilution claims like plaintiffs' can be understood as both derivative and direct.[25] According to the Court of Chancery, with respect to the question of who – the corporation or the stockholder individually – suffered the alleged harm, the harmful effects can be felt at both the corporate and stockholder level. While the corporation is harmed because it issued too much stock for too little consideration, the stockholders are also directly harmed because the over-issuance of shares transfers economic value and voting power from the diluted stockholder.[26] As to the second *Tooley* question, the Court of Chancery explained that the claim could be remedied at either the corporate level – by requiring a greater investment in exchange for the issued stock – or, at the stockholder level – ''by adjusting the rights of the stock or invalidating a portion of the shares.''[27]

Despite having determined that plaintiffs' wrongful dilution claims could be direct under *Tooley*, the Court of Chancery continued its analysis. Vice Chancellor Laster recognized that, even though the *Tooley* test indicated that it can be direct, a claim of this type might nevertheless be restricted by *Gentile* and its progeny to derivative classification unless the challenged transactions were undertaken at the behest, and inured to the benefit, of a majority or controlling stockholder.[28] The Court of Chancery cited *Feldman* as one decision in which it had ''struggled with how to interpret *Gentile* and its potential to undercut the traditional characterization of stock dilution claims as derivative.''[29] As noted above and by the Court of Chancery in *Carsanaro*, the *Feldman* court had declined to permit a stock dilution claim that did not involve a majority stockholder to go forward because to do so ''would swallow the general rule that equity dilution claims are solely derivative.''[30] Given that *Carsanaro*, like *Feldman*, did not involve a controlling stockholder, Vice Chancellor Laster was thus required to consider what, if any, limitation should be placed on stockholders' rights to pursue direct claims alleging dilution or expropriation, regardless of the Court of Chancery's determination of standing under a pure *Tooley* analysis.

The Vice Chancellor ultimately departed from the limitation applied in cases like *Feldman*, finding that Delaware Supreme Court precedent does not support such a limitation,[31] and also reasoning, importantly, that ''*the core insight of dual injury applies to non-controller issuances in which insiders participate*.''[32] Rather than being limited to transactions involving a majority or controlling stockholder, Vice Chancellor Laster concluded that stock dilution claims could also

[18] 906 A.2d at 101 (emphasis added).

[19] 956 A.2d 644 (Del. Ch. 2007).

[20] *See also Rhodes v. Silkroad Equity*, C. A. No. 2133-VCN, 2007 BL 73964, at *6 (Del. Ch. July 11, 2007) (concluding that certain claims are derivative under *Tooley* but finding them simultaneously direct under *Gentile* without elaboration in terms of the *Tooley* factors); *Gatz v. Ponsoldt*, 925 A.2d 1265 (Del. 2007) (reversing the Court of Chancery's pre-*Gentile* decision on the basis of *Gentile*).

[21] 956 A.2d at 655 (quoting *In re Berkshire Realty Co., Shareholder Litigation*, No. 17242, 2002 BL 1382, at *4-5 (Del. Ch. Dec. 18, 2002)).

[22] *Id.* at 657.

[23] Plaintiffs also alleged that their relative share of merger proceeds was diluted even further as a result of a management incentive plan (the ''MIP'') the board adopted in connection with the merger. Under the MIP, the board members received awards equal to approximately 18% of the merger consideration.

[24] *Carsanaro v. Bloodhound Technologies Inc.*, C.A. No. 7301-VCL, 2013 BL 69339, at *28 (Del. Ch. Mar. 15, 2013).

[25] *Id.* at *29-30.

[26] *Id.*

[27] *Id.* at *30.

[28] *Id.* at *31.

[29] *Id.*

[30] *Id.*

[31] *Id.* (citing *Gatz*, 925 A.2d at 1274; *Gentile*, 906 A.2d at 100; *Loral Space & Commc'ns Inc. v. Highland Crusader Offshore P'rs, L.P.*, 977 A.2d 867, 869 (Del. 2009)).

[32] *Id.* (emphasis added).

be direct where a breach of the duty of loyalty is adequately alleged against a majority of the board. On this point, the Court of Chancery stated:

> Standing will exist if a controlling stockholder stood on both sides of the transactions. *Standing will also exist if the board that effectuated the transaction lacked a disinterested and independent majority*. Standing will not exist if there is no reason to infer disloyal expropriation, such as when stock is issued to an unaffiliated third party, as part of an employee compensation plan or when a majority of disinterested and independent directors approves the terms. *The expropriation principle operates only when defendant fiduciaries (i) had the ability to use the levers of corporate control to benefit themselves and (ii) took advantage of the opportunity*.[33]

Applying this principle, the Court of Chancery held that the complaint stated a direct claim with respect to the challenged transactions ''because each financing challenged in the complaint was a self-interested transaction implicating the duty of loyalty and raising an inference of expropriation.''[34]

[33] *Id.* at *32.

[34] *Id.* (holding that the complaint also stated a direct claim challenging the transactions because plaintiffs had adequately pled that the directors who approved the transactions ''can be regarded as a control group for purposes of *Gentile*''); *id.* at *33 (explaining this part of his decision, Vice Chancellor Laster made clear that it was not intended to undermine the distinction between (i) controllers who would owe fiduciary duties to the minority with respect to transactions reviewed under the *Kahn v. Lynch Communication Systems, Inc.* line of decisions, and (ii) directors whose combined shares may give rise to an inference of control. The Court made clear that this distinction is still intact and therefore directors whose combined holdings may give rise to an inference of control ''do not become a control group for purposes of *Lynch* simply because they took board level action'').

Questions Remaining After *Carsanaro*

As discussed at the outset of this article, Vice Chancellor Laster's *Carsanaro* decision can be read as a step towards reconciliation of the accepted *Tooley* test for identifying direct claims with the reasoning of *Gentile* that permitted claims for expropriation to be pled directly despite the traditional view of such claims as exclusively derivative. By focusing not on differential treatment of stockholder groups, but rather on the fiduciary duties at play in the allegedly dilutive transaction – whether owed by a controlling stockholder (as in *Gentile*) or by directors (as in *Carsanaro*) – the Vice Chancellor appears to have created a means of analyzing dilution claims that does not rely on the special injury test or its reasoning. In at least one respect, however, *Carsanaro* leaves room for uncertainty as to how future claims for dilution will be analyzed under *Tooley*. The Vice Chancellor's conclusion that such claims may be brought directly only where they implicate a fiduciary's disloyalty (rather than a mere breach of care) preserves *Gentile* to the extent that claims that are arguably direct under *Tooley* may still be pursued only in a derivative action when they do not cross the requisite ''line in the sand.''[35] Nonetheless, *Carsanaro* provides a faithful application of *Tooley* in this context without having to consider the sometimes inconsistent traditional understanding of claims for equity dilution as exclusively derivative. It is yet to be seen, however, whether *Carsanaro* marks only a single and not-to-be-extended step, or instead a march towards still broader availability of standing to bring direct claims in cases of alleged equity dilution.

[35] *Id.* at *31.

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