

Delaware Supreme Court DECISIONS

Gatz v. Ponsoldt: Delaware Supreme Court's Recent Clarification of Direct v. Derivative Claims

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THE DELAWARE SUPREME COURT'S recent decision in *Gatz v. Ponsoldt*¹ provides further clarification in a developing line of cases on what suits may be filed directly on behalf of shareholders or derivatively on behalf of a corporation. The procedural posture of this case is lengthy,² but the decision before the Supreme Court on appeal dealt with the Chancery Court's dismissal of the case based on the plaintiffs' failure to meet the Rule 23.1 demand requirement for derivative actions. The transactions generating the issues on appeal are also complex, but essentially involve a large minority shareholder using his *de facto* control to engineer transactions that, in two simultaneous steps, transferred majority voting control to him and then sold that voting control to a third party.³ The end result was that the company's public shareholders – who previously had held the company's majority stock interest – became minority shareholders in an enterprise controlled by the third party.⁴

The Supreme Court, in an *en banc* decision, reversed the Chancery Court's holding that the shareholder plaintiffs' claim of dilution was exclusively derivative, and held that the claim could be brought directly by the shareholder plaintiffs.⁵ The significance of this decision is two-fold with regard to (i) the application of *In re Tri-Star Pictures, Inc.*,⁶ and its recent progeny, *Gentile v. Rossette*,⁷ in holding that claims for dilution may be directly filed by a class of shareholders where a significant or controlling shareholder causes a corporation to engage in a transaction wherein shares having more value than what the corporation received in exchange are issued to the controller, thereby increasing the controller's percentage of stock ownership in the corporation and diluting the public shareholders' interest in the corporation, and then those benefits are simultaneously transferred to a third party; and (ii) the Supreme Court's use of equity to look beyond the form and to the substance of the underlying transactions.

I. Application of the *Tri-Star/Rossette* Doctrine

The Supreme Court held that shareholder plaintiffs may bring a direct claim where a transaction constituted an expropriation of voting power and economic value to a third party, to the corresponding detriment of the public shareholders, which was accomplished by a shareholder's *de facto* control of the corporation.⁸ In reaching this holding, the Supreme Court's analysis centered on its holdings in *Tri-Star* and *Rossette*.⁹

In *Tri-Star*, a class of minority shareholders challenged a business combination between Tri-Star and its largest shareholder, the Coca-Cola Company.¹⁰ The plaintiffs alleged, among other things, that Coca-Cola caused Tri-Star to issue an excessive number of Tri-Star shares in exchange for Coca-Cola shares that had a lesser value.¹¹ The Supreme Court found that Coca-Cola, without any significant cost to itself (*i.e.*, Coca-Cola did not suffer a dilution of cash value, voting power or ownership percentage), obtained approximately an 80% interest in Tri-Star, which in turn reduced the public shareholders' interest to approximately 20%. Based on these facts, the Supreme Court reversed the Chancery Court's dismissal of the complaint and held that the plaintiffs suffered harm that was unique to them individually and that could be remedied by bringing a direct claim.¹²

Similarly, *Rossette* involved a suit brought by a minority group of shareholders against the company's former directors and CEO/controlling shareholder.¹³ The suit arose from a self-dealing transaction in which the CEO/controlling shareholder forgave the corporation's debt to him in exchange for being issued stock whose value allegedly exceeded the value of the forgiven debt – thereby reducing the cash value and the voting power of the public shareholders' minority interest.¹⁴ The corporation was subsequently acquired after the debt conversion, and the acquiring company later filed for bankruptcy and was liquidated.¹⁵ The minority shareholders brought suit to recover the value of which they claimed to have been wrongfully deprived in the debt conversion.¹⁶ The Supreme Court reversed the Chancery Court's dismissal of the suit on the grounds that the claim was exclusively derivative (and that as a result of the merger, the plaintiffs had lost standing to assert a derivative claim), finding that the claim alleged the same kind of expropriation of economic value and voting power that is indistinguishable from *Tri-Star*.¹⁷ The Supreme Court explained:

There is, however, at least one transactional paradigm – a species of corporate overpayment claim – that Delaware case law recognizes as being both derivative and direct in character. A breach of fiduciary duty claim having this dual character arises 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 stock-

Gatz v. Ponsoldt: Delaware Supreme Court's Recent Clarification of Direct v. Derivative Claims

holder 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. Because the means used to achieve that result is an overpayment (or "over-issuance") of shares to the controlling stockholder, the corporation is harmed and has a claim to compel the restoration of the value of the overpayment. That claim, by definition, is derivative.

But, the public (or minority) stockholders also have a separate, and direct, claim arising out of that same transaction. Because the shares representing the overpayment embody both economic value and voting power, the end result of this type of transaction is an improper transfer – or expropriation – of economic value and voting power from the public shareholders to the majority or controlling stockholder. For that reason, the harm resulting from the overpayment is not confined to an equal dilution of the economic value and voting power of each of the corporation's outstanding shares. A separate harm also results: an extraction from the public shareholders, and a redistribution to the controlling stockholder, of a portion of the economic value and voting power embodied in the minority interest. As a consequence, the public shareholders are harmed, uniquely and individually, to the same extent that the controlling shareholder is (correspondingly) benefited. In such circumstances, the public shareholders are entitled to recover the value represented by that overpayment ... directly and without regard to any claim the corporation may have.¹⁸

II. Equity: Substance Over Form

The *Gatz* decision is also noteworthy for the Supreme Court's use of equity to reject one significant factual difference between *Gatz* and the facts alleged in *Tri-Star* and *Rossette* (i.e., in *Gatz* the expropriation directly benefited a third party – not the corporation's controlling shareholder). In finding this factual difference unpersuasive, the Supreme Court reasoned that the first transaction in *Gatz* "was a *Tri-Star/Rossette* expropriation of voting power and economic value from a public shareholder by and to the controller shareholder," and that the simultaneous second transaction involved "a transfer of the benefits of that expropriation by the controlling shareholder to the third party."¹⁹ Because these two component transactions were timed to occur simultaneously rather than sequentially, the Supreme Court explained that the company's public shareholders should not lose their entitlement to seek redress in a direct action under the *Tri-Star/Rossette* doctrine.²⁰ Of importance is the Supreme Court's statement:

It is the very nature of equity to look beyond form to the substance of an arrangement. "Equity will not

permit one to evade the law by dressing what is prohibited in substance in the form of that which is permissible." ... In our view, that difference in form, which is a product of transactional creativity, should not affect how the law views the substance of what truly occurred, or how the public shareholders' claim for redress should be characterized.²¹

Some commentators have questioned the impact of this language on the doctrine of independent legal significance (i.e., the mere fact that a transaction cannot be accomplished under one statutory provision does not invalidate it if a different statutory method of consummation exists). However, the *Gatz* decision is not inconsistent with the doctrine of independent legal significance, because that doctrine does not alter "the fundamental rule that inequitable actions in technical conformity with statutory law can be restrained by equity."²² What the *Gatz* decision does mean is that when structuring a transaction, attorneys should look beyond whether the transaction's form complies with the law and to whether the substance of the transaction passes muster under equitable principles.

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ENDNOTES

¹ No. 298, 2006, 2007 Del. LEXIS 167 (Del. Apr. 16, 2007).

² *Id.* at *2-*3, n.1, 2, 3 (explaining the procedural posture and citing the Chancery Court's prior decisions).

³ *Id.* at *5-*20.

⁴ *Id.* at *5.

⁵ The Supreme Court explained that the Chancery Court's decision was "based on then-existing case law, [and] an intervening legal development occurred while this appeal was pending, ... [which] bore importantly on the issue of whether the dismissed claims were derivative, direct, or both." *Id.* at *4.

⁶ 634 A.2d 319 (Del. 1993).

⁷ 906 A.2d 91 (Del. 2006).

⁸ *Gatz*, 2007 Del. LEXIS 167, at *33.

⁹ *Id.* at *34-*38.

¹⁰ 634 A.2d at 320.

¹¹ *Id.* at 325-26.

¹² *Id.* at 332.

¹³ 906 A.2d at 93.

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.* at 101-03.

¹⁸ *Gatz*, 2007 Del. LEXIS 167, at *36-*38 (quoting *Rossette*, 906 A.2d at 100).

¹⁹ *Id.* at *40.

²⁰ *Id.* at *43.

²¹ *Id.* at *44, *45.

²² *In re Pure Res. S'holder Litig.*, 808 A.2d 421, 434 (Del. Ch. 2002) (citing *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437, 439 (Del. 1971) ("Inequitable action does not become permissible simply because it is legally possible.")).

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