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DIRECT, DERIVATIVE, OR BOTH? DELAWARE SUPREME COURT ANSWERS QUESTIONS OF CLAIM OWNERSHIP AND STANDING

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On December 20, 2016, the Delaware Supreme Court held in *El Paso Pipeline GP Company, L.L.C. v. Brinckerhoff*[1] that a limited partner's challenge to a limited partnership's "dropdown" transaction[2] was a derivative claim belonging to the limited partnership, and that the Plaintiff had lost standing to pursue the claim following the partnership being acquired in a subsequent merger.

This article, like the Supreme Court Decision, focuses on the standing issues presented by this unique case, and puts them in their historical context. Standing, in this context, is a litigation variant of a more fundamental question about claim ownership as between an entity's equityholders and the entity itself:[3] if the claim is owned by equityholders, then they have standing to assert it directly; if the claim is owned by the entity, then an equityholder's standing to assert the claim is derivative of the entity's, and subject to the heightened standards of Rule 23.1 and the demand requirement. As *El Paso* reaffirms, an equityholder's derivative standing is also subject to divestment at any time.

Among other lessons, the Supreme Court Decision establishes that the two-part *Tooley* test will be used to determine whether a given claim is direct or derivative, even where that claim arises in the contractual context of a limited partnership or LLC agreement. As explained below, under the *Tooley* test as reframed and applied in the Supreme Court Decision, a claim will be deemed derivative, and thus owned by the entity, unless an equityholder plaintiff can show harm to the equityholders without any concurrent harm to the entity.[4]

A Brief Primer on the Delaware Law of Standing in Representative Litigation Involving Business Entities

Determining Whether a Claim is Direct or Derivative: The Delaware courts have been

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answering this question for nearly 100 years.[5] In doing so, they have developed and refined analytical tools to address this question, beginning with including the "special injury" test.

As its name implies, Delaware courts applying the "special injury" test distinguished between derivative claims owned by the company and direct claims owned by an equityholder by asking whether the plaintiff suffered a harm independent of any harm done to the company.[6] As with any litigation-developed doctrine, there were refinements and variants in specific cases,[7] but this "special injury" test was the law for more than five decades, beginning no later than 1953.[8]

It was swiftly replaced by the Delaware Supreme Court in its 2004 decision in *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*[9] The *Tooley* Court expressly overruled the "special injury" test, describing it as "not helpful to a proper analytical distinction between direct and derivative actions."[10] In its place, the Court established a new test: "The analysis must be based solely on the following questions: Who suffered the alleged harm—the corporation or the suing stockholder individually—and who would receive the benefit of the recovery or other remedy?"[11]

With respect to *Tooley*'s first question, the Court cited Chancellor Chandler's decision in *Agostino v. Hicks* with approval for its articulation of the analysis, which looks much like the former "special injury" test.[12] It asks: "Looking at the body of the complaint and considering the nature of the wrong alleged and the relief requested, has the plaintiff demonstrated that he or she can prevail without showing an injury to the [company]?"[13] As framed by *Agostino*, this is a useful analytical tool to help judges decide and lawyers litigate cases.[14]

Can a Claim Be Both Direct and Derivative? In their decades of deciding whether claims in a given case are direct or derivative, the Delaware Courts developed a third possibility. These decisions acknowledged that "[t]here 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."[15] Under these decisions, a "dual" claim arose "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 stock-

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holder, and a corresponding decrease in the share percentage owned by the public (minority) shareholders."[16]

The scope of the category of dual claims expanded with the Court of Chancery's 2013 decision in *Carsanaro v. Bloodhound Technologies, Inc.*[17] In *Bloodhound*, the Court illustrated in a series of examples how "[a] dilutive stock issuance can have the requisite dual character," even if there is no controlling stockholder, if "the facts alleged support an actionable claim for breach of the duty of loyalty."[18] Absent a controller, a dual claim challenging a dilutive stock issuance could still be pled "if the board that effectuated the transaction lacked a disinterested and independent majority."[19] As interpreted by the Court of Chancery in *Bloodhound*, *Gentile* applies to dilution claims "when defendant fiduciaries (i) had the ability to use the levers of corporate control to benefit themselves and (ii) took advantage of the opportunity."[20]

The Court of Chancery's Standing Decision

On April 20, 2015, the Delaware Court of Chancery held the General Partner[21] liable for $171 million, finding that it caused the Partnership to overpay by that amount in purchasing assets from a related party.[22] Approximately five months prior to the Liability Decision, and shortly after trial, the Partnership was acquired in the Merger.[23]

As a result, the General Partner filed an incongruous post-trial motion to dismiss, arguing that the "overpayment claim" at issue was classically derivative, and the Merger had therefore severed the Plaintiff's standing. In opposition, the Plaintiff argued that although he had pled and tried his claim derivatively, he could recast his claim after trial as direct or at least dual-natured because it arose from a breach of contract, and therefore survived the Merger.

On December 2, 2015, the Court of Chancery denied the Defendant's motion to dismiss.[24] In its opinion, the Court of Chancery first evaluated the claim from a dichotomous direct-versus-derivative perspective and concluded that it was direct. Next, the Court explained why it viewed the claim as having dual aspects. Finally, the Court considered the various policy and equitable considerations that, in its view, supported its decision that the Plaintiff still had standing.

Determining Whether the Claim Is Direct or Derivative: The Court of Chancery began its analysis by tackling the core question posed to it by the General Partner's motion, concluding that if it were forced to choose between classifying the Plaintiff's claim as either exclusively direct or exclusively derivative, then it would classify it as direct.[25]

In a simplified reading, the Court's analysis seemed to depend heavily on the contractual nature of the limited partnership entity in which this claim arose.[26] But the Court dug deeper, analogized to the claims historically brought directly by stockholders in the corporate context, and attempted to draw entity-independent lines of demarcation: "The direct claims governed by Delaware law that equity investors most commonly advance rely on particular rights that a holder of an equity security can exercise by virtue of being the owner of that security."[27] In particular, the Court observed that direct claims include: (1) claims expressly provided by statute to equityholders; (2) claims to enforce contract rights vested in equityholders by an entity's constitutive documents;[28] and (3) claims challenging violations of contractual constraints on managerial authority.[29]

Applying those principles, the Court characterized the Plaintiff's claim as one for breach of contract, and in particular, breach of the conflict-of-interest section of the El Paso partnership agreement. And because the Court characterized the claim as a contract claim, it reasoned that the two-part *Tooley* test for distinguishing direct and derivative claims did not apply. In support, the Court relied on the result reached in *Tooley* itself, which "confirmed the direct nature of a stockholder's cause of action for injury to its contractual rights as a stockholder, even when a plaintiff asserts the same contractual right in a representative capacity on behalf of all stockholders."[30]

In short, the Court of Chancery concluded that the Plaintiff was exercising his rights under a contract to which he was a party, and therefore the claim was direct, if the universe of claims were neatly divided into direct and derivative claims.

Could the Claim Be Both Direct and Derivative? The Court of Chancery then introduced to its analysis the concept of dual claims, which it defined those that "exist because some injuries affect both the corporation and the stockholders and can be remedied either at the corporate or the stockholder level."[31] According to the Court's application of *Tooley*, rather than being exclusively derivative or direct, "[t]he more appropriate way to view the cause of action that led to the Liability Award is as a dual-natured claim with aspects that are both derivative and direct."[32]

Applying the first part of the *Tooley* test, the Court of Chancery concluded that both the Partnership and the unaffiliated limited partners suffered harm as a result of the challenged transaction. The Court acknowledged that the Partnership was harmed in the "most obvious" way—by overpaying for an asset.[33] The Court concluded, however, that the unaffiliated limited partners were directly harmed by the transaction because, by virtue of its related-party nature, it "reallocate[d] value" from them to the General Partner and its affiliates.[34] As the Court reasoned, the unaffiliated limited partners bore the full loss suffered by the Partnership because the affiliates of the General Partner stood on both sides of the transaction, and thus received a benefit that offset the loss they would have felt proportionately as equityholders in the Partnership.[35] Accordingly, the Court concluded that the challenged transaction "superficially left the Partnership $171 million poorer, but it actually enriched the General Partner at the expense of the limited partners by reallocating $78.66 million from the limited partners to the General Partner."[36]

With respect to *Tooley*'s second part, the Court reasoned that the dual nature of the injury lent itself to two alternative, but functionally equivalent remedies. On the one hand, the Court again acknowledged that "the entity-level remedy is the most obvious," and would have required a repayment to the entity of the amount by which it was found to have overpaid in the challenged transaction.[37] But the Court also endorsed the possibility of a payment by the General Partner to the unaffiliated limited partners to account for what the Court deemed the "extraction of value" by the General Partner.[38] This remedy, according to the Court's analysis, would "fix[] the overall harm by recasting the transaction as one in which all partners receive *pro rata* treatment."[39]

Finally, the Court evaluated competing policy arguments about how the claim should be characterized. On the derivative side of the ledger, the Court acknowledged the beneficial effects, at the outset of a case, of the demand requirement and Court of Chancery Rule 23.1.[40] Those policy interests were outweighed, in the Court's view, by the policy interests of avoiding a windfall to the General Partner and allowing it to evade accountability for its alleged misdeeds by allowing the Merger to terminate the litigation once the case reached beyond the pleadings stage.[41] Balancing these factors, the Court suggested an innovation in Delaware law, at least for dual claims, that would prioritize the derivative aspects at the pleadings stage and the direct aspects in the event the legal existence of the subject company ends while litigation is pending.[42]

But in any event, having characterized the claim as direct, or at least as one having direct aspects, the Court concluded that the Plaintiff retained standing through the Merger, and denied the Defendant's post-trial motion to dismiss.

The Supreme Court Decision

The Supreme Court parted ways with the Court of Chancery at the outset of its analysis, and so it reversed. The high court held that *Tooley* applied notwithstanding the contractual nature of the claim, and that under *Tooley,* the claim was derivative. As a result, the Supreme Court held that the Merger terminated the Plaintiff's standing, and therefore did not reach the Court of Chancery's innovative proposal for how to treat dual claims.

Determining Whether the Claim Is Direct or Derivative: The Supreme Court Decision departed from the Court of Chancery's Standing Decision at the outset. The Court of Chancery had held *Tooley* inapplicable to claims brought by equityholders to assert contractual rights inherent in an entity's constitutive documents. The Supreme Court disagreed, holding that the contractual nature of the Plaintiff's claim "does not alone answer the question as to whether [the Plaintiff's] claim was derivative, direct, or both."[43] In the Supreme Court's view, "[t]he reality that limited partnership agreements often govern the territory that in corporate law is covered by equitable principles of fiduciary duties does not make all provisions of a limited partnership agreement enforceable by a direct claim."[44] Instead, the Court applied *Tooley*, having concluded that the Plaintiff's claim arose from "breach of a contractual duty owed to the Partnership."[45]

Applying *Tooley*, the Supreme Court relied heavily on the traditional view that the harm caused by an overpayment claim is borne by the entity that allegedly overpaid.[46] In its analysis, the Supreme Court weighed heavily the Plaintiff's own pleadings and proof, all of which focused solely on the harm to the entity and the amount by which the entity purportedly overpaid.[47] In the high court's view, there was no room to look further through the entity for any equityholder-level harm because the Plaintiff failed to produce evidence of any.[48] As a result, the Supreme Court held that *Tooley* applied, and that the only harm pled or proved was to the entity, making this a "classically derivative" claim.[49] Having concluded that the claim was exclusively derivative, the Supreme Court concluded that the Plaintiff lost standing as a result of the Merger.[50]

The Supreme Court Decision thus establishes the validity of *Tooley* to decide standing questions, and gives some useful guidance to trial court judges and lawyers about how and in what circumstances it will apply. Following *El Paso*, *Tooley* applies to any claim to enforce rights that belong, at least in part, to a company. In a corporate case, a fiduciary duty suit against the board of directors invokes *Tooley* because directors owe fiduciary duties to both the corporation and its stockholders.[51] In an alternative entity case, a claim for breach of the entity's constitutive contract invokes *Tooley* if it involves contractual duties owed, at least in part, to the entity itself.[52] The fact that a plaintiff is a party to that constitutive contract does not give the plaintiff standing to assert all claims for breach of that contract directly.

Could the Claim Be Both Direct and Derivative? In a concurring opinion to the Supreme Court Decision, the Chief Justice of the Delaware Supreme Court cast doubt on the continuing vitality of dual claims.[53] The concurring opinion took issue with Court of Chancery's extension of *Gentile* out of the "one transactional paradigm" involving a corporation transacting with its controlling stockholder and into a case involving a limited partnership transacting with an affiliate of its general partner.[54] More broadly, the Chief Justice took aim at *Gentile* itself, characterizing it as a "confusing decision" and questioning aloud whether it serves any useful purpose in giving direct dilution claims to minority stockholders "even though they were already stockholders in a controlled company."[55]

Thus, the Supreme Court Decision refused to extend *Gentile* into the limited partnership context, and the concurring opinion may have marked the beginning of the end of *Gentile*'s doctrinal life.

Conclusions

Nine-figure judgments being reversed are rare. Rarer still are post-trial motions to dismiss on standing grounds. *El Paso* had both. Yet despite its procedural oddities, *El Paso* teaches important lessons for future cases and future transactions about how to determine whether a claim is owned by a company or its equityholders, and what will happen to it in the event of a merger.

The importance of whether a claim is direct or derivative depends on the procedural posture of the litigation and the lifecycle of the subject company. At the pleadings stage of a case, characterizing a claim as derivative subjects it to Court of Chancery Rule 23.1 and the demand requirement. These can be significant hurdles for a plaintiff, especially in a case challenging a third-party transaction, but they promote the important interests of internal dispute resolution and preserve the authority of those charged with governing business entities.

But if, as in *El Paso*, the company pursues a final-stage transaction before a pending case reaches its final stage, the characterization of a claim as direct or derivative takes on case dispositive importance. It refocuses the inquiry out of litigation and back to claim ownership. As in *El Paso*, an equityholder's derivative standing to litigate on behalf of a company is coterminous with his or her equity ownership, and if that ends, whether by merger or otherwise, so will the litigation.[56]

In light of the harsh realities of this result,[57] and the policy reasons in favor of the demand requirement and Rule 23.1,[58] the Court of Chancery suggested in its Standing Decision that "Delaware law should split the atom of its now-unitary analysis" and should "treat dual-natured claims differently for purposes of claim initiation, when Rule 23.1 and the demand doctrine should apply, and claim termination, when the plaintiff should be able to continue to litigate a dual-natured cause of action post-merger as a direct claim."[59] Because the Supreme Court Decision held that the claim was exclusively derivative, it did not address the Standing Decision's novel approach to litigation involving dual claims.[60]

As a result, as *El Paso* amply demonstrates, defendants in derivative litigation always possess the trump card of a merger to end derivative litigation. But deploying the trump card is not a risk-free proposition: a derivative plaintiff may always "challenge the fairness of the merger" in which his litigation is terminated "by alleging that the value of his claims was not reflected in the merger consideration."[61] As a result, transaction planners must be mindful of the target's litigation assets, including pending and potential derivative claims, when evaluating a sale of the company. Well-advised sell-side decision-makers must procure independent legal advice to permit them to assess and, if necessary, bargain for the risk-adjusted present value of those litigation assets. They can be held to account for a failure to do so in subsequent merger litigation.

ENDNOTES:

[1]2016 WL 7380418 (Del. Dec. 20, 2016) (the "Supreme Court Decision").

[2]A "dropdown" transaction is an industry term for a transaction in which a limited partnership purchases assets from its "sponsor" entity, which is typically a related party affiliated with its general partner.

[3]Although this case arose in the context of a publicly traded Delaware limited partnership, the principles at issue in this case are framed by the courts as "entity neutral" principles of Delaware entity litigation that would apply in the corporate context or LLC context as well. As a result, wherever possible, this article uses the "entity neutral" terms "equityholder" and "entity" or "company" rather than the more precise, contextual terms "stockholder" and "corporation," or "limited partner" and "limited partnership."

[4]Supreme Court Decision, at *10.

[5]*See, e.g.*, *Fleer v. Frank H. Fleer Corp.*, 125 A. 411, 414 (Del. Ch. 1924) (addressing whether plaintiff

sought "to secure rights which belong to the corporation" or "rights which, if they are well founded, belong to the complainant individually").

[6]*See, e.g.*, *In re Tri-Star Pictures, Inc. Litig.*, 634 A.2d 319, 330 (Del. 1993); *Kramer v. W. Pac. Indus., Inc.*, 546 A.2d 348, 351 (Del. 1988); *Moran v. Household Int'l, Inc.*, 490 A.2d 1059, 1070 (Del. Ch. 1985), *aff'd*, 500 A.2d 1346 (Del. 1985); *Bokat v. Getty Oil Co.*, 262 A.2d 246, 249 (Del. 1970).

[7]For example, in *Bokat*, the Delaware Supreme Court interpreted the "special injury" test as requiring an equityholder seeking to assert a direct claim to establish that the injury did not fall proportionately across all equityholders. 262 A.2d at 249. This concept was intuitively useful, in the sense that a harm to the company would indirectly affect the company's equityholders proportionately. But this concept proved to be "confusing and inaccurate" because it ignored the possibility that an indisputably direct claim, such as a claim for false or misleading disclosures, could also harm equityholders proportionately. *See Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1037 (Del. 2004).

[8]*Elster v. Am. Airlines, Inc.*, 100 A.2d 219, 222 (Del. Ch. 1953) ("There are cases, of course, in which there is injury to the corporation and also special injury to the individual stockholder. In such case a stockholder, if he should so desire, may proceed on his claim for the protection of his individual rights rather than in the right of the corporation. The action would then not constitute a derivative action.").

[9]845 A.2d 1031 (Del. 2004).

[10]*Tooley*, 845 A.2d at 1035.

[11]*Id.*

[12]*Id.* at 1036 (citing *Agostino v. Hicks*, 2004 WL 443987, at *7 (Del. Ch. Mar. 11, 2004)).

[13]*Id.* (quoting *Agostino*, 2004 WL 443987, at *7).

[14]The same cannot be said for *Tooley*'s second question, which asks who gets the benefit of any recovery. This is another way of asking who owns the claim, the equityholders or the company. This is the question judges and lawyers look to *Tooley* to answer.

[15]*Gentile v. Rossette*, 906 A.2d 91, 105 (Del. 2006); *accord Gatz v. Ponsoldt*, 925 A.2d 1265 (Del. 2007); *In re Tri-Star Pictures*, 634 A.2d 319.

[16]*Gentile*, 906 A.2d at 99-100.

[17]65 A.3d 618 (Del. 2013).

[18]*Bloodhound*, 65 A.3d at 655-59.

[19]*Id.* at 658.

[20]*Id.* at 659.

[21]This article refers to El Paso Pipeline GP Company L.L.C. as the "General Partner," and refers to El Paso Pipeline, L.P. as "El Paso" or the "Partnership."

[22]*See generally In re: El Paso Pipeline Partners, L.P. Derivative Litig.*, 2015 WL 1815846 (Del. Ch. Apr. 20, 2015) (the "Liability Decision").

[23]This article refers to the acquisition of El Paso by an affiliate of Kinder Morgan, Inc. as the "Merger."

[24]*See generally In re: El Paso Pipeline Partners, L.P. Derivative Litig.*, 132 A.3d 67 (Del. Ch. Apr. 20, 2015) (the "Standing Decision").

[25]Standing Decision, at 75.

[26]Standing Decision, at 86 ("Brinckerhoff sued to enforce a contract to which he and the other limited partners were parties. They had standing to enforce that claim individually and directly. Their claim therefore survived the Merger, and it now can be remedied by awarding the unaffiliated limited partners at the time of the Merger their *pro rata* share of the Liability Award.").

[27]*Id.*

[28]*Id.* at 87 ("The availability of a direct cause of action in these situations comports with Delaware's longstanding recognition that the DGCL, the certification of incorporation, and the bylaws together constitute a multi-party contract among the directors, officers, and stockholders of the corporation.").

[29]*Id.* at 86-87.

[30]*Id.* at 99.

[31]Standing Decision, at 103.

[32]*Id.* at 75.

[33]*Id.* at 104.

[34]*Id.* at 105-111.

[35]*Id.*

[36]Standing Decision, at 111.

[37]*Id.*

[38]*Id.*

[39]*Id.*

[40]*Id.* at 112-117.

[41]Standing Decision, at 112-117.

[42]*Id.*

[43]Supreme Court Decision, at *8.

[44]*Id.* at *9.

[45]*Id.*

[46]*Id.* at *10-13. The Court of Chancery had acknowledged as much, characterizing this harm as the "most obvious." Standing Decision, at 104.

[47]Supreme Court Decision, at *10-13.

[48]*Id.*

[49]*Id.*

[50]*Id.* at *13-14.

[51]*E.g.*, *Schoon v. Smith*, 953 A.2d 196, 206 (Del. 2008); *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1280 (Del. 1989); *accord Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 179 (Del. 1986).

[52]Supreme Court Decision, at *9 ("Because Brinckerhoff's claim sounds in breach of a contractual duty owed to the Partnership, we employ the two-pronged *Tooley* analysis to determine whether the claim 'to enforce the [Partnership's] own rights must be asserted derivatively' or is dual in nature such that it can proceed directly.") (footnotes omitted).

[53]*Id.* at *14.

[54]*Id.* ("Sufficient for today is that we refuse to extend *Gentile* further, to a situation where a limited partnership was already firmly under the control of the general partner and where the transaction under attack had no effect whatsoever on limited partner voting rights.").

[55]*Id.*

[56]This rule is subject to two limited, and doctrinally tenuous exceptions. For an exhaustive discussion of the two *de jure* exceptions to the general rule that a merger terminates an equityholder's derivative standing, see S. Michael Sirkin, *Standing at the Singularity of the Effective Time: Reconfiguring Delaware's Law of Standing Following Mergers and Acquisitions*, 69 BUS. LAW. 429 (2014) ("*Standing at the Singularity*").

[57]Standing Decision, at 84 ("In contrast to a Rule 23.1 analysis, where strong claims typically proceed notwithstanding a derivative characterization, *Lewis v. Anderson* operates as a bright-line, one-size-fits-all rule that effectively terminates claims regardless of merit.").

[58]*Id.* at 83 ("In a close case, it makes sense for the law to err on the side of giving the board of directors the benefit of the doubt and control over litigation assets. If the claim is strong, it typically will survive a Rule 23.1 analysis regardless. Similar policies apply to limited partnerships, where a general partner manages the entity.").

[59]*Id.* at 85.

[60]In light of the concurring opinion, however, which limits the scope of dual claims and potentially marks their demise, it is possible this new approach will never actually be deployed in practice.

[61]Supreme Court Decision, at *1. For a thorough and critical exploration of the rules that apply to those types of cases, see *Standing at the Singularity*.

FTC MERGER REMEDIES REPORT SIGNALS TOUGHER ENFORCEMENT

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The Federal Trade Commission staff have completed a new study evaluating its process for designing and implementing merger remedies and the success of the remedies it has imposed in the past. Its report—*The FTC's Merger Remedies 2006-2012: A Report of the Bureaus of Competition and Economics*—follows a similar retrospective study from 1999 and also follows a number of recent matters where the agency's remedies were seen to have failed. Consistent with the experience of merging parties in recent years, the findings of this report confirm that the government will continue closely to scrutinize divestitures and other relief offered to remedy competition issues in transactions between companies with horizontal (at the same level of the supply chain) and vertical (at different levels) relationships. Although this report was issued by just one of the two federal antitrust agencies, and on the last day of the Obama Administration, the analysis and identified best practices are likely to resonate with the new leadership at

