

Delaware Supreme Court: In Overruling *Gentile v. Rossette* the Court Throws Out the Exception to *Tooley*'s "Simple" Test to Distinguish Between Direct and Derivative Claims

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On September 20, 2021, in a unanimous decision, the Delaware Supreme Court overruled *Gentile v. Rossette*, reversing a Court of Chancery decision holding that plaintiffs had direct standing to challenge a green energy company's private placement of common stock for allegedly inadequate consideration. [Brookfield Asset Management v. Rosson](#), 2021 WL 4260639 (Del. 2021) (Valihura, J.). The court agreed with defendants that there was a clear conflict between *Tooley v. Donaldson, Lufkin & Jennette, Inc.*, establishing the test to distinguish direct claims from derivative claims, and *Gentile* which served as an exception to *Tooley*. In support of its decision, the court noted the difficulty that courts have had in applying *Gentile* in a logically consistent way and *Gentile*'s erosion of *Tooley*'s simple analysis.

Background and Procedural History

The consolidated class action complaint alleged three counts of breach of fiduciary duty^[1] arising from the controlling stockholders of a green energy company causing it to issue its stock in a private placement for inadequate value, allegedly diluting both the financial and voting interest of the minority stockholders. The counts were putatively brought both derivatively and directly. Defendants moved to dismiss plaintiffs' direct claims on the basis that they were entirely derivative.

Subsequently, a merger involving the energy company occurred and the energy company's public stockholders ceased to have any interest in the energy company, and all of its assets, liabilities, rights and causes of action became the acquirer's property. In light of the merger, the trial court dismissed the derivative counts of the complaint. The Court of Chancery later denied defendants' motion to dismiss holding that while plaintiffs failed to state direct claims under *Tooley*, they did state direct claims to challenge the private placement under *Gentile*, noting that the claims were predicated on similar facts. The Delaware Supreme Court accepted an interlocutory appeal from the Court of Chancery's opinion.

The Alleged Overpayment Falls "Neatly" Into Tooley's Derivative Category

The court identified the central issue on appeal as whether plaintiffs had direct standing to pursue their claims or whether their claims were entirely derivative. The court explained that if their claims were only derivative, then the merger extinguished them and they lacked standing to pursue them. The court stated that *Tooley* created a “simple” test to distinguish direct claims from derivative claims.^[2] The court then held that the “claim is derivative because [plaintiffs] allege an overpayment (or over-issuance) of shares to the controlling stockholder constituting harm to the corporation for which it has a claim to compel the restoration of the value of the overpayment.” The court stated that “[c]learly, the gravamen of the Complaint is that the Private Placement was unfair and that [the energy company] suffered harm.”

In discussing *Gentile*’s analytical tension with *Tooley*, the court summarized the complaint’s allegations as follows: the private placement allegedly harmed the energy company by issuing shares for an unfairly low price and harmed the stockholders indirectly through economic and voting power dilution. The court then concluded that “the harm to the stockholders was not independent of the harm to the Company, but rather flowed indirectly to them in proportion to, and via their shares in, [the company].” The court stated that this alleged corporate overpayment falls “neatly” into *Tooley*’s derivative category. The court also stated that it saw “no practical need for the *Gentile* carve-out.”

As to *stare decisis*, the court pointed out that 15 years was enough time to pass since *Gentile* was decided for the court to “properly say that the practical and analytical difficulties courts have encountered in applying it reflect fundamental unworkability and not growing pains[.]”

^[1] Count I was against an alternative asset manager, and two of its affiliates as controlling stockholders. Count II was against certain directors of the energy company and Count III was against the energy company’s CEO.

^[2] Under *Tooley*, “whether a stockholder’s claim is direct or derivative must turn *solely* on the following questions: (1) who suffered the alleged harm (the corporation or the stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?” (emphasis in original).

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