TOOLEY BROOKS NO EXCEPTIONS—EQUITY DILUTION IS DIRECT

Tooley's corporate pie versus the "classical" view of equity dilution as a derivative claim

Christine J. Chen and Y. Carson Zhou*

ABSTRACT 2
INTRODUCTION 2
I. WHY IT MATTERS: LITIGATING DERIVATIVE VERSUS DIRECT CLAIMS 6
II. DELAWARE LAW TODAY ON EQUITY DILUTION; ITS "SPECIAL INJURY" ORIGINS 14
A. "Special Injury" Survives Tooley: Gatz and J.P. Morgan Chase 15
B. "Special Injury" Expands: Gentile and its Critics 19
C. The Law Today on Equity Dilution Claims: Brookfield and Sheldon 22
III. APPLYING *TOOLEY* TO EQUITY DILUTION CLAIMS 26
A. Understanding Tooley: The Corporate Pie 27
B. Tooley Prong One: Equity Dilution Harms Only Stockholders and Not the Entity 29
C. Tooley Prong Two: What if the Prongs Conflict? 34
IV. APPLYING THE CORPORATE PIE; EXAMPLES OF DIRECT VERSUS DERIVATIVE SUITS 36
A. Split Rights 37
B. Tooley's Dependence on the Form of Consideration: Stock Repurchases, Stock Issuances (Poison Pills), Mixed Consideration, and Convertible Notes 39
C. Tooley As Applied To Other Common Claims 44
V. CONCLUSION: STARE DECISIS AND EQUITY DILUTION 48

* Columbia Law School, J.D. 2018, and Harvard Law School, J.D. 2015, respectively. The views and opinions expressed in this Article are solely the authors' own, and do not reflect, and are not in any way associated with, any individuals, institutions, organizations, or business entities with which the authors have been, are currently, or will be affiliated.

ABSTRACT

This Article argues that the Delaware rule that equity "dilution claims are classically derivative" is not consistent with the *Tooley* test, which sets forth that whether a claim is direct or derivative "turn[s] solely on" who "suffered the harm" and who "recover[s]." Examining the caselaw behind the "classical[]" rule reveals that the underlying reasoning is a relic from the "special injury" framework that *Tooley* overruled. It does not comport with *Tooley* as the company suffers no harm when the company issues stock. That is because stock that the company itself holds is not a company asset, has no economic value, and cannot be voted. Indeed, it is well established in the literature that treasury stock is valueless. Put another way, compare the company and its assets to a pie, of which all stockholders own a slice. When an entity issues new shares for cash, pre-existing stockholders hold a smaller percentage of the pie, but the total size of the pie increases. Stockholders hold the same-sized slice as before so long as equity purchasers paid a fair price. When share purchasers do not pay enough, however, existing stockholders find that their slices of the pie have shrunk, even though the pie itself has not. In fact, the pie is now bigger due to the cash payment. An equity issuance does not transfer value out of the company; it only redistributes existing stockholders' economic and voting rights in the company to the equity purchasers. The entity is uninjured and only its ownership structure is affected. Rather, it is existing stockholders who pay the bill when the company issues equity, and it is therefore stockholders who are harmed—not the company—when a company dilutes stockholders by overpaying in stock. Under *Tooley*, that is a direct claim.

INTRODUCTION

In 2004, the Delaware Supreme Court adopted the *Tooley* test for distinguishing direct breach of fiduciary duty claims belonging to stockholders and derivative breach of duty claims owned by the company. Whether a claim is direct or derivative would henceforth "turn *solely* on the following questions: (1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?"[1] At the same time, Delaware courts today continue to hold that claims challenging an equity issuance that dilutes existing stockholders'

[1] Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1033 (Del. 2004).

ownership stakes are derivative and belong to the entity. We argue that this approach to equity dilution is (i) a doctrinal anomaly inconsistent with *Tooley* because dilution harms only stockholders and no entity-level injury occurs, and (ii) a relic of the pre-2004 special injury framework that *Tooley* explicitly overruled.

Whether a claim is deemed direct or derivative has real-world litigation significance. Plaintiffs can bring direct claims at all times. But only current stockholders can assert claims on behalf of the company, and only when the board fails to properly consider those claims or is unable to do so because of disabling conflicts of interest. Derivative claims are also subject to a heightened pleading standard. And persons who lose their stock by operation of a merger also lose their ability to bring derivative claims.

As the Delaware Supreme Court pronounced in *Brookfield Asset Mgmt., Inc. v. Rosson*, "[c]lassically, Delaware law has viewed as derivative claims by shareholders alleging that they have been wrongly diluted by a corporation's overpayment of shares."[2] Yet the reasoning and chain of citations behind this proposition trace not only to the substantial body of special injury jurisprudence that Delaware courts issued in the 80s and 90s, but all the way to *Elster v. Am. Airlines*,[3] a 1953 decision that is the progenitor of the special injury concept.[4] At risk of oversimplification, the special injury test focused on whether a would-be direct claimant has alleged a harm "separate and distinct from that suffered by other shareholders."[5] *Elster* held that equity dilution is derivative because any proportionate reduction in a stockholder's stake "would apply to the stock of all other stockholders as well."[6]

Even though *Tooley* overruled the special injury test, two lines of post-*Tooley* equity-dilution cases emerged based on *Elster*'s reasoning: (i) equity dilution absent a controlling stockholder is "classically" derivative because all stockholders share in the dilution, but (ii) a so-called "dual-natured" *Gentile* claim could be brought directly when an entity issues "'excessive'"

---

[2] Brookfield Asset Mgmt., Inc. v. Rosson, 261 A.3d 1251, 1266 (Del. 2021).
[3] Elster v. Am. Airlines, 100 A.2d 219, 220–21 (Del. Ch. 1953), *disapproved of by* Tooley, 845 A.2d at 1031.
[4] *See infra* Part II.
[5] Moran v. Household Int'l, Inc., 490 A.2d 1059, 1070 (Del. Ch. 1985), *aff'd,* 500 A.2d 1346 (Del. 1985). Special injury was not so much a single test as it was a bundle of maxims and rules that courts adopted gradually over the course of five decades. We attempt here to distill special injury into a sentence or two to ease understanding and to hone-in on certain elements that we believe have survived *Tooley*'s attempt to replace special injury with a single unifying, bright-line rule. Our efforts to do so do not represent a comprehensive description of special injury.
[6] *Elster*, 100 A.2d at 222.

shares to a controller, thereby enlarging the controller's stake at the minority's expense.[7] Delaware law treats the former scenario as derivative because all stockholders share the same injury, whereas the latter claim could (until recently) be brought directly because only minority stockholders were harmed, while the controller benefitted. Both lines of cases explicitly relied on *Elster*'s progeny; some decisions even cited *Elster*.[8]

In *Brookfield*, the Delaware Supreme Court recognized *Gentile*'s special injury foundations and overruled *Gentile* and its progeny as inconsistent with *Tooley*. Yet at the same time, *Brookfield* reaffirmed reasoning in the former line of cases holding that equity dilution claims are derivative, even though that conclusion too is a special injury holdover. Indeed, both *Tooley and Brookfield* expressly rejected the idea that whether a claim is direct or derivative should be informed by whether an injury accrues to only some as opposed to all stockholders.[9] But by virtue of seven decades of repetition, the "traditional" or "classical" view that equity dilution claims are derivative is now firmly entrenched as blackletter Delaware law despite *Tooley*'s exclusive application.

While this axiom is frequently repeated and rarely questioned, it is inconsistent with *Tooley*. *Tooley* holds that injury to the stockholder leads to a direct claim while injury to the entity is derivative. Dilutive equity issuances harm stockholders but not the entity. Stock holds value only insofar as it is a proxy for a portion of the entity, and stock that the company itself holds or has otherwise not yet issued has no economic value. At the same time, statutory law bars companies from voting their own stock. As a result, the corporation's assets do not decrease when it issues stock. In fact, as the amount of stock a company can issue is limited only by the charter and can be increased via amendment, a company can keep issuing stock until it is near-worthless without affecting the company's total enterprise value. Rather, it is existing stockholders who pay the bill for any equity issuance, as the transaction redistributes their economic and voting rights to the equity purchasers. In a fair transaction, that dilution is offset by consideration paid for the issued shares because the corporation's assets increase proportionally.

---

[7] *Compare, e.g.*, Feldman v. Cutaia, 956 A.2d 644 (Del. Ch. 2007) (holding that equity dilution claims are derivative), *aff'd*, 951 A.2d 727 (Del. 2008), *and In re* J.P. Morgan Chase & Co. S'holder Litig., 906 A.2d 808 (Del. Ch. 2005) (holding the same), *aff'd*, 906 A.2d 766 (Del. 2006), *with* Gentile v. Rossette, 906 A.2d 91 (Del. 2006) (recognizing dual-natured claim where controller causes a dilutive equity issuance).

[8] *See, e.g.*, Gatz v. Ponstadt, 2004 WL 3029868, at *7, *7 n.49 (Del. Ch. Nov. 5, 2004), *rev'd on other grounds*, 925 A.2d 1265 (Del. 2007).

[9] Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1037 (Del. 2004); Brookfield Asset Mgmt., Inc. v. Rosson, 261 A.3d 1251, 1266 (Del. 2021).

In an unfair transaction, the company gains the consideration paid, but existing stockholders are excessively diluted because they overpaid, and gave up more of their economic and voting rights in the company than the purchasers paid in consideration.

Put another way, compare the company and its assets to a pie, of which all stockholders own a slice proportionate in size to their ownership. When an entity issues new shares to new stockholders in exchange for fair consideration, pre-existing stockholders hold a smaller percentage of the pie, but the total size of the pie increases, and stockholders are left holding the same-sized slice as before the issuance. But when recipients of new shares do not pay enough for those shares, existing stockholders' ownership of the corporation are disproportionately diluted; their percentage of the pie is smaller, and the size of the pie has not expanded proportionally. The unfair transaction has not, however, made the pie itself any smaller: the entity is uninjured. That is why it is existing stockholders, not the company, who are harmed when a company dilutes stockholders by issuing new shares for insufficient consideration. Under *Tooley*, that is a direct claim.

In short, this Article addresses what the authors believe to be an inconsistency in how Delaware courts currently apply *Tooley*. In the sections below, we hope to demonstrate that the "classical" axiom that "dilution claims are classically derivative" does not comport with *Tooley*, and claims that a corporation has overpaid in its own stock are not derivative, but direct.

First, we explain why differentiating derivative from direct claims matters—particularly to practitioners—by describing the real-world differences between litigating each type of claim.

Second, we walk through how the current rule that equity dilution claims are derivative is a relic of the "special injury" test that survived *Tooley* and recount how this idea retrenched in present-day Delaware law. In the process, we discuss *Gentile* and its demise, and provide an overview of the current state of Delaware law on dilution claims.

Third, we apply *Tooley* to equity dilution and explain why dilution claims necessarily are derivative under *Tooley*. We suggest that *Tooley*'s dual questions—who was harmed and to whom a remedy would accrue—are best answered by assessing whether a challenged transaction has shrunk the whole corporate pie (an entity-level injury) or only reduced stockholders' share of that pie (an individual injury). We explore why dilution harms stockholders only and not the entity. We also examine how Delaware courts wield wide discretion to fashion remedies and have set up the potential for conflict between *Tooley*'s prongs by suggesting both stockholder and entity-level recoveries for equity dilution. We suggest that who suffered the harm must control because conditioning the threshold issue of standing on the

form of recovery—a discretionary factor that varies from case to case and is decided only after trial—would make *Tooley* unworkable.

Finally, we apply the corporate pie paradigm to various complex transactions challenged in Delaware courts and distinguish direct from derivative. We argue that consistent application of the *Tooley* framework necessarily suggests that dual-natured claims exist; and further posit that a claim is both direct and derivative when entities purchase assets using either (i) a mix of stock and cash or (ii) convertible notes that can be either repaid in cash or redeemed for stock. We note that such claims do not make *Tooley* any harder to apply, and that concerns about double recovery are easily resolved by courts' current methods for dealing with litigations brought by competing stockholder groups challenging the same transaction.

I. WHY IT MATTERS: LITIGATING DERIVATIVE VERSUS DIRECT CLAIMS

A stockholder bringing a claim derivatively on an entity's behalf must litigate pursuant to a substantively different set of laws and procedural rules than if they brought the same claim directly. That is because derivative claims are an equitable exception to the traditional rules of standing requiring that claims be brought only by their holders. The most significant difference between litigating derivative and direct claims is the demand requirement; derivative plaintiffs must either first make a litigation "demand" on the entity's board or equivalent governing body, or else demonstrate that such a demand would be futile. But there are other differences too. These include the continuous ownership rule, which requires that plaintiffs must maintain their stake in the entity throughout litigation, as well as heightened judicial scrutiny at the pleading stage.

The Demand Requirement. Even at the inception of derivative litigation, courts recognized that, as representative actions technically asserted on behalf of another, derivative suits should be allowed only upon an additional showing of need.[10] In 1881, reasoning that derivative claims

---

[10] In 1843, in Foss v. Harbottle, the Court of Chancery of England and Wales famously dismissed stockholder claims against corporate directors because "the conduct with which the Defendants are charged in this suit is an injury not to the Plaintiffs exclusively; it is an injury to the whole corporation." 67 ER 189, 202 (Ch. 1843). But the Vice Chancellor simultaneously recognized that:

> [i]f a case should arise of injury to a corporation by some of its members, for which no adequate remedy remained, except that of a suit by individual

"belong[] to the corporation," the United States Supreme Court articulated a "demand" requirement whereby stockholders seeking to bring suit on behalf of an entity should first have to show that it would be futile to seek "redress" from "the managing body of the corporation":

> [B]efore the shareholder is permitted in his own name, to institute and conduct a litigation which usually belongs to the corporation, he should show, to the satisfaction of the court, that he has exhausted all the means within his reach to obtain, within the corporation itself, the redress of his grievances, or action in conformity to his wishes. He must make an earnest, not a simulated effort, with the managing body of the corporation, to induce remedial action on their part, and this must be made apparent to the court.[11]

By 1911, the "demand" concept had made its way to Delaware.[12] Yet, despite Delaware's increasing importance over the next few decades as the epicenter both of new incorporations and the development of United States corporate law, the concept at first had minimal significance. That is because Delaware courts initially applied the "demand" requirement as no more than a pleading formality; demand was futile so long as a demand would require directors to initiate litigation "conducted by themselves against themselves."[13] Functionally, that meant demand was futile in any suit alleging a breach of fiduciary duty against corporate directors. This did not change until the 1980s, when a sharp uptick in M&A activity also triggered a wave of takeover litigation. Both federal courts and the Delaware Court of Chancery issued several opinions in the early 80s dismissing derivative suits

---

> corporators in their private characters, . . . I cannot but think that . . . the claims of justice would be found superior to any difficulties arising out of technical rules respecting the mode in which corporations are required to sue.

Id. The Court of Chancery crafted the antecedents of today's derivative claims in the decades before and after *Foss* as an equitable exception to the law of standing so that stockholders could seek entity-level recovery when management was unwilling or unable to do so. *See* Burt S. Prunty Jr., *The Shareholders Derivative Suit: Notes on its Derivation*, 32 N.Y.U. L. REV. 980, 980-85 (1957) (describing beginnings of stockholder representative suits). Derivative litigation emerged in the United States at around the same time. *See* Robinson v. Smith, 3 Paige Ch. 222 (N.Y. Ch. 1832).

[11] Hawes v. Oakland, 104 U.S. 450, 460 (1881).

[12] Ellis v. Penn Beef Co., 80 A. 666, 668 (Del. Ch. 1911) ("Nor is it necessary, under the facts in the case, for the stockholder to have applied to the corporation to institute the suit to cancel the stock, as it appears clearly that such application would be futile.").

[13] Harden v. E. States Pub. Serv. Co., 122 A. 705, 707 (Del. Ch. 1923). *See also, e.g.*, Penn Beef, 80 A. at 668; Miller v. Loft, Inc., 153 A. 861, 862 (Del. Ch. 1931) ("The rule is well settled in this State that if by reason of hostile interest or guilty participation in the wrongs complained of, the directors cannot be expected to institute suit, or if a suit is instituted it is apparent that the directors would not be the proper persons to conduct it, no demand upon them to institute suit is requisite to enable a stockholder to sue in behalf of the corporation.").

for failure to plead demand futility.

In 1984, the Delaware Supreme Court's seminal *Aronson v. Lewis* decision affirmed the view that a company acting through its board of directors should control its own litigation and resuscitated the demand requirement.[14] Reversing a Court of Chancery denial of a motion to dismiss, the Supreme Court held that the trial court must assess whether a plaintiff stated "particularized facts" calling into question whether an entity's directors could properly exercise their business judgment in assessing a litigation demand.[15] The Supreme Court also ruled that "the mere threat of personal liability for approving a questioned transaction, standing alone, is insufficient to challenge either the independence or disinterestedness of directors" in a demand analysis.[16]

As refined by subsequent cases, the *Aronson* framework largely still in effect today is a significant hurdle for derivative plaintiffs. ***First***, both Delaware and federal law subject the demand inquiry to a heightened "particularized" pleading standard that is more stringent than the Rule 12(b)(6) pleading standard applicable to direct claims. This is of particular importance in Delaware, where a motion to dismiss under Rule 12(b)(6) must be denied unless the plaintiff cannot "recover under any reasonably conceivable set of circumstances susceptible of proof."[17] Reasonable conceivability is a "'minimal'" pleading standard and is commonly understood to be a more plaintiff-friendly standard than the federal "plausibility" pleading standard.[18] Imposition of a heightened "particularity" standard for derivative claims that is more stringent than the basic federal pleading standard is thus a shift in defendants' favor, particularly in Delaware courts, at the pleading stage of litigation.

Second, the substantive inquiry is different. A direct plaintiff need only state valid claims upon which relief can be granted. A stockholder seeking to bring derivative claims on an entity's behalf, however, must first establish that the decision to sue cannot be entrusted to the entity's board. Such a

[14] Aronson v. Lewis, 473 A.2d 805 (Del. 1984).
[15] *Id.* at 814.
[16] *Id.* at 815.
[17] Cent. Mortg. Co. v. Morgan Stanley Mortg. Cap. Holdings LLC, 27 A.3d 531, 536 (Del. 2011).
[18] Cambium Ltd. v. Trilantic Cap. Partners III L.P., 36 A.3d 348 (Del. 2012) ("In *Central Mortgage*, comparing Delaware's 'conceivability' standard to the federal 'plausibility' standard, this Court explained that the former 'is more akin to possibility while the federal plausibility standard falls somewhere beyond mere possibility but short of probability.' Moreover, unlike the conceivability standard, the plausibility pleading standard 'invites judges to determin[e] whether a complaint states a plausible claim for relief and draw on ... judicial experience and common sense.'").

stockholder must demonstrate either that they (i) "demand[ed]" that the "company's board of directors" bring suit and such demand was wrongly refused; or (ii) that such "demand would be futile" due to disabling conflicts on the part of a majority of the board at the time the complaint was filed.[19] In other words, a derivative complaint must allege facts calling into question the business judgment of a majority of directors, "director-by-director."[20] As an illustrative example, even if a derivative plaintiff asserted claims against a self-dealing controlling stockholder that could survive a motion to dismiss for failure to state a claim, the case would still be dismissed for failure to plead demand futility if the plaintiff cannot also allege facts specific to a majority of directors showing that they cannot disinterestedly evaluate a demand to bring that claim.[21]

Contemporaneous and Continuous Ownership. In addition to meeting the demand requirement, derivative plaintiffs must also satisfy the contemporaneous and continuous ownership rules. A direct plaintiff that has suffered an injury in fact sufficient to establish standing may bring suit at any time within the applicable statute of limitations period (or, for equitable claims, the equivalent period imposed by the laches doctrine). But under the Contemporaneous and Continuous Ownership Rules, a derivative plaintiff "must not only be a stockholder at the time of the alleged wrong and at time of commencement of suit but . . . must also maintain shareholder status throughout the litigation."[22] Delaware courts adhere to this "'bright line rule'" "'closely'" and with few exceptions.[23]

Significantly, that means that, whereas class actions can be maintained even after a stockholder plaintiff has lost their ownership interest in an entity by operation of a merger, derivative plaintiffs that are cashed out in a merger lose their derivative standing to maintain the litigation, and whatever claims are outstanding must be dismissed. For example, in 2010, stockholders of Massey Energy Company brought derivative claims arising from the directors' alleged failure to oversee mine safety, leading to a mining accident that took 29 lives.[24] The Court of Chancery remarked that the

[19] United Food & Com. Workers Union & Participating Food Indus. Emps. Tri-State Pension Fund v. Zuckerberg, 262 A.3d 1034, 1047 (Del. 2021).
[20] *Zuckerberg*, 262 A.3d at 1059.
[21] *See* Teamsters Union 25 Health Servs. & Ins. Plan v. Baiera, 119 A.3d 44, 67 (Del. Ch. 2015) ("[N]either the presence of a controlling stockholder nor allegations of self-dealing by a controlling stockholder changes the director-based focus of the demand futility inquiry").
[22] Lewis v. Anderson, 477 A.2d 1040, 1046 (Del. 1984).
[23] Feldman v. Cutaia, 956 A.2d 644, 660 (Del. Ch. 2007) (citations omitted), *aff'd,* 951 A.2d 727 (Del. 2008).
[24] *In re* Massey Energy Co. Derivative & Class Action Litig., 160 A.3d 484 (Del. Ch. 2017).

plaintiffs "clearly would state a viable claim for relief that could be pursued in this action," but dismissed the suit because the plaintiffs "lost standing to pursue the claim by virtue of [a] [m]erger" where stockholders exchanged their Massey shares for cash.[25]

Special Litigation Committees. Unlike in the direct claim context, entities embroiled in derivative litigation also have an opportunity to retake control of the litigation after a court has deemed demand to be futile or wrongfully refused by forming a Special Litigation Committee of independent and disinterested directors (an "SLC").[26] The SLC must then be granted full and exclusive authority to evaluate the claims alleged and determine whether it is in the company's interest to pursue, settle, or dismiss those claims.[27] Formation of an SLC usually deprives a plaintiff of control of the litigation immediately, as the SLC will, upon appointment, typically move to stay the litigation while it conducts its investigation; Delaware courts will grant the stay absent "highly unusual circumstances."[28] Once the SLC completes its investigation, it will often either settle with defendants on the entity's behalf, or move the court to terminate the litigation under a standard "akin" to summary judgment.[29] While the SLC process is intricate, complex, and poses new and different risks for defendants in derivative litigation, it offers an alternative set of litigation options that are not available at all to defendants against direct claims. The SLC mechanism exists purely because derivative claims belong to the entity and not the stockholder plaintiff, so no comparable mechanism exists in the direct claim context where stockholder plaintiffs own and control their own claims.

Recovery of Damages. The fact that derivative claims belong to the company also results in different treatment of liability and settlement payouts. Whereas recoveries for direct claims belong to individual plaintiffs,

---

[25] *Id.* at 497.

[26] *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 788 (Del. 1981).

[27] *See In re* InfoUSA, Inc. S'holders Litig., 2008 WL 762482 (Del. Ch. 2008) (approving of "mandatory" language in resolution vesting "SLC with the 'full and exclusive authority' to investigate the pending claims and to 'determine' what course of action the Company should take).

[28] Biondi v. Scrushy, 820 A.2d 1148, 1148 n.41 (Del. Ch. 2003).

[29] Sutherland v. Sutherland, 968 A.2d 1027, 1029 (Del. Ch. 2008). In rare circumstances, SLCs have sided with plaintiffs and permitted plaintiff stockholders to prosecute their claims on an entity's behalf. *See* Letter to the Court, *In re* Oracle Corp. Derivative Litig., C.A. No. 2017-0337-SG (Del. Ch. Aug. 15, 2019) (Oracle SLC "determined that the Lead Plaintiff should be allowed to proceed with the derivative litigation on behalf of Oracle" after failed mediation and settlement attempts); Tchrs' Ret. Sys. of La. v. Aidinoff, 900 A.2d 654 (Del. 2006) (AIG SLC "agreed to allow" plaintiffs to proceed with their claims "[i]n a compromise").

derivative recoveries often go to the entity to which the derivative claim belongs.[30] Stockholders benefit, but only indirectly through increased entity value as a result of the payments. As discussed further at Section III.C., *infra*, an important caveat is that courts have considerable discretion to fashion a remedy tailored to the facts of each case, and courts can mix and match entity-level claims and recoveries with stockholder recoveries and claims where appropriate.

Class vs. Derivative Settlements in Delaware. Delaware also treats class and derivative settlements differently. ***First***, while both are representative settlements that require court oversight and approval, the procedural requirements for obtaining approval of derivative settlements in Delaware are more lax compared to class settlements. Del. Ch. R. 23, which governs class actions, provides for a long list of requirements that a lead plaintiff must meet to properly represent a class, and the trial court must explicitly find that those requirements are met and certify a class before approving a class settlement. By comparison, Del. Ch. R. 23.1, which governs derivative actions, lacks equivalent language. Recently, the Delaware Supreme Court held that this textual difference meant that, whereas the trial court must "make a finding that the plaintiff is an adequate class representative" when reviewing a class settlement, the trial court need not do so when reviewing a derivative settlement: "Absent an express requirement in Court of Chancery Rule 23.1 that the Court determine the adequacy of a derivative plaintiff before approving a settlement of litigation, we are reluctant to imply such a requirement."[31] While the Supreme Court recommended that the "Court of Chancery Rules Committee consider amendments to Rule 23.1, to include whether to make the plaintiff's adequacy an express requirement to maintain a derivative action" and "to consider whether an adequacy finding must be made before court approval of a derivative litigation settlement," no such requirement has yet been included in Rule 23.1 as of writing.[32]

Second, plaintiffs' attorneys who secure a class-wide recovery in a direct action, or an entity-wide recovery in a derivative suit, could receive a wildly different fee award from attorneys who agree to settle derivative claims via a direct payment to stockholders. Plaintiffs' counsel in both derivative and direct actions are paid a percentage of the "benefit" they conferred on the company or the class. In the derivative context, defendants who agree to a monetary settlement typically pay the entity rather than

[30] *See, e.g.*, Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1033 (Del. 2004).
[31] Griffith v. Stein, 283 A.3d 1124, 1137, 1138-39 (Del. Aug. 16, 2022).
[32] *Id.* at 1139.

stockholders directly, and plaintiffs' counsel get a percentage of that amount. In at least one case, however, the parties settled a derivative litigation in return for $3.25 million payable, not to the company, but directly to the company's minority stockholders.[33] The Delaware Court of Chancery awarded plaintiffs' counsel 20%–$650,000—of the payment.[34] This settlement structure obviated any payment to the defendants, who owned 89.25% of the company. If the settlement had been structured as an entity-wide payment, the implied derivative "benefit" would have been over $30 million, and the fee over $6 million, even though the defendants would have retained all but $3.25 million of the purported entity-level benefit. Plaintiffs' counsel was professionally obligated to present the settlement to their clients, who accepted the deal. But when plaintiffs' counsel sought a $6 million fee based on the $30 million implied derivative value of the settlement, the court held that, due to the "present posture of the litigation and the current state of the record, I am not able to value the benefit conferred at any amount greater than $3.25 million."[35]

The chart below summarizes some of the practical differences discussed above between litigating derivative claims and litigating direct claims:

Differences Between Litigating Derivative versus Direct Claims	
Direct Claims	**Derivative Claims**
Must meet Rule 12(b)(6) pleading standard: "plausibility" in federal courts, "reasonable conceivability" in Delaware courts.	Must meet heightened Rule 23.1 standard by pleading "particularized" facts.
Must allege facts that state a claim against defendants.	In addition to stating a claim against defendants, must either allege facts showing (i) that half of the directors of the entity are not capable of making a disinterested decision to bring litigation against the defendant in question; or (ii) that plaintiff made a litigation demand on the board and the demand was wrongly refused.

[33] Baker v. Sadiq, 2016 WL 4375250, at *6 (Del. Ch. Aug. 16, 2016).
[34] *Id.* at *7.
[35] *Id.* at *6.

Differences Between Litigating Derivative versus Direct Claims	
Must initiate litigation before the end of a statutory limitations period or equitable equivalent under the laches doctrine.	In addition to meeting statutory limitations and laches requirements, plaintiff must have been an entity unit- or stockholder at the time of the alleged injury, and must then continue to maintain that ownership interest through the end of the litigation.
Although a court must approve an attempt to settle or dismiss a class action, stockholder plaintiffs otherwise maintain control over dismissal or compromise of direct claims.	Should defendants lose a motion to dismiss, an entity can still take control of a derivative litigation from plaintiff and attempt either to settle or dismiss the claims through the Special Litigation Committee process.
Typically, damages are recovered directly by plaintiff or members of a certified class.	Typically, damages are recovered by the entity—plaintiff and stakeholders in the entity only recover indirectly through increased entity value.
To settle direct claims on behalf of a class, lead plaintiff (and also defendants) must meet rigorous requirements for settlement, including demonstrating their adequacy as class representatives.	While derivative claims also require court approval, the procedure for settling derivative claims in Delaware is simpler than for settling a class claim. For example, the court does not need to make an explicit finding that the plaintiff is an adequate entity representative.
Plaintiff's counsel is awarded fees as a percentage of the class-wide recovery.	Plaintiff's counsel is awarded fees as a percentage of the recovery even when a derivative settlement is structured as a direct payment to minority stockholders that has a much higher implied entity-wide value.

II. DELAWARE LAW TODAY ON EQUITY DILUTION; ITS "SPECIAL INJURY" ORIGINS

Before the 2004 *Tooley* decision, stockholders seeking to bring a direct claim typically had to allege a "special injury." The concept was first introduced in the 1953 *Elster* decision, which dealt with an allegedly dilutive stock issuance to senior management.[36] Holding that plaintiff's claim was derivative, the court noted that dilution "would apply to the stock of all other stockholders as well," and suggested that, to bring a direct claim, plaintiff could have alleged a "special injury to the individual stockholder."[37] With the spate of corporate governance litigation in the 80s, Delaware courts attempted to synthesize "special injury" into a rough framework for deciding derivative standing by (at risk of oversimplifying a sprawling set of concepts) distinguishing corporate rights from stockholder-specific rights like voting, and harm to all stockholders or the company from harm to specific subsets of stockholders:

> To set out an individual action, the plaintiff must allege either 'an injury which is separate and distinct from that suffered by other shareholders,' or a wrong involving a contractual right of a shareholder, such as the right to vote, or to assert majority control, which exists independently of any right of the corporation.[38]

Tooley attempted to do away with this "amorphous and confusing concept" entirely: "the concept of 'special injury' . . . is not helpful to a proper analytical distinction between direct and derivative actions. We now disapprove the use of the concept of 'special injury' as a tool in that analysis."[39] In its place, *Tooley* established the present rule that whether a claim is direct or derivative "must turn ***solely*** on the following questions: (1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?"[40]

---

[36] Elster v. American Airlines, 100 A.2d 219, 220–21 (Del. Ch. 1953).
[37] *Id.* at 222.
[38] Moran v. Household Intern., Inc., 490 A.2d 1059, 1070 (Del. Ch. 1985) (citations omitted).
[39] Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1035 (Del. 2004).
[40] *Id.* at 1033. *Tooley* established into law that whether a claim is direct or derivative would from then on turn only on who suffered the alleged harm and would recover the damages. But the idea originated elsewhere. As *Tooley* notes, Chancellor Chandler "suggest[ed]" in

Ostensibly, *Tooley*'s language and reasoning allows for no exceptions to its eponymous rule. But while in theory *Tooley* had streamlined the law into a single, workable test, in reality the pre-*Tooley* case law continued to exert considerable influence on cases decided post-*Tooley*. We demonstrate below that post-*Tooley* Delaware cases that resolved challenges to equity dilution relied on and applied pre-*Tooley* modes of analysis that found such claims to be derivative and not direct under the special injury test. This pre-*Tooley* determination is now firmly entrenched as blackletter Delaware law despite originating from the special injury concept, which *Tooley* had expressly overruled.

A. "Special Injury" Survives Tooley: Gatz and J.P. Morgan Chase

It is unsurprising in an industry wedded to precedent that special injury continued to influence Delaware jurisprudence after it ceased to be law. *Tooley* itself relied on a slew of past cases, some of which the opinion expressly endorsed as examples of "proper analysis."[41]

Just months after *Tooley*, the Court of Chancery, stating that *Tooley* "cit[ed] with approval" the 1953 *Elster* decision that introduced the special injury concept, remarked in *Gatz v. Ponsoldt* that "claims of dilution" are "traditionally understood as derivative."[42] The *Gatz* court held that a claim challenging an equity issuance was derivative, reasoning that the "only cognizable injuries" were either "failure to act in the best interest of [the company] or the breach of the promise to [the company] not to exercise the options" to initiate a dilutive issuance. The *Gatz* court characterized both as harms "inflicted upon the corporation."[43] But the equity issuance (setting aside other allegations) not only had no negative impact on the company's

Agostino v. Hicks "that the inquiry should be whether the stockholder has demonstrated that he or she has suffered an injury that is not dependent on an injury to the corporation." *Id.* at 1036 (citing Agostino v. Hicks, 2004 WL 443987, at *7 (Del. Ch. Mar. 11, 2004)). *Agostino* in turn references language from Justice Horsey's decision in Kramer v. W. Pac. Indus., Inc.: "For a plaintiff to have standing to bring an individual action, he must be injured ***directly*** or ***independently*** of the corporation." 546 A.2d 348, 351 (Del. 1988).

[41] *Tooley*, 845 A.2d at 1039.

[42] Gatz v. Ponsoldt, No. Civ.A. 174-N, 2004 WL 3029868, at *7, *7 n.49 (Del. Ch. Nov. 5, 2004). The Supreme Court would overturn the Court of Chancery's decision three years later because of "an intervening legal development"—the Supreme Court's decision in *Gentile* recognized the existence of dual-natured claims, which, under *Gentile*'s reasoning, included the claims at issue in *Gatz*. Gatz v. Ponsoldt, 925 A.2d 1265, 1268 (Del. 2007). *See* discussion of *Gentile* and its progeny *infra* Section II.B.

[43] *Gatz*, 2004 WL 3029868, at *7.

market value,[44] it resulted in defendants "delivering a promissory note to [the company] with a principal amount of approximately $2.44 million": the company actually gained value.[45] The only potential "injury" was that the "interest of the Public Shareholders fell from 89.1% to 61.1%" without adequate compensation. The *Gatz* court's response was that "a corporation is free to enter into (in good faith) numerous transactions, all of which may result legitimately in the dilution of the public float. Such dilution is a natural and necessary consequence of investing in a corporation."[46]

But that does not change the fact that when such dilution is not offset by payment that commensurately increases the value of the company, diluted stockholders are injured while the company itself has only gotten bigger. To be clear, $2.44 million could well have been fair compensation for the dilution at issue in *Gatz*—but that is a different question than whether or not such claims are direct or derivative.

J.P. Morgan, issued half a year after *Gatz*, offers clear demonstration of the pre-*Tooley* "special injury" underpinnings for the idea that equity dilution is derivative. JPMC stockholders brought a class action against JPM's board challenging the board's decision to issue JPMC shares to acquire Bank One at an implied 14% premium. Extensively citing special injury cases and applying special injury reasoning, the court deemed the claim to be derivative and dismissed the suit for failure to plead demand futility.[47]

With a nod to *Gatz*, the court quoted three pre-*Tooley* cases in what was supposed to be a *Tooley* analysis:

> Although "dilution claims emphasizing the diminishment of voting power have been categorized as direct claims," "[they] are individual in nature [only] where a significant stockholder's interest is increased at the sole expense of the minority." . . . In fact, Delaware case law states that "if a board of directors authorizes the issuance of stock for no or grossly inadequate consideration, the corporation is directly injured and shareholders are injured derivatively."[48]

---

[44] *See* discussion *infra* Section III.B. (Treasury stock has no value to the company.)
[45] *Gatz*, 2004 WL 3029868, at *2.
[46] *Id.* at *7.
[47] *In re* J.P. Morgan Co. S'holder Litig., 906 A.2d 766, 812 (Del. Ch. 2005).
[48] *Id.* at 818 (quoting Gentile v. SinglePoint Fin., 2003 WL 1240504, at *5 n.36 (Del. Ch. Mar. 5, 2003); *In re* Paxson Commc'n Corp. S'holders Litig., 2001 WL 812028, at *5 (Del.Ch. July 12, 2001); Avacus Partners, L.P. v. Brian, 1990 WL 161909, at *6 (Del.Ch. Oct. 24, 1990).).

All three internal quotations in the passage above were originally statements discussing or applying the special injury test. As the unabbreviated quote from one of the three cases points out, pre-*Tooley*, "[c]laims for share dilution have typically been treated as derivative claims because of the lack of a 'special injury.' In contrast, dilution claims emphasizing the diminishment of voting power have been categorized as direct claims."[49]

"Special injury" permeates *J.P. Morgan*'s reasoning despite the opinion's invocation of *Tooley*. Echoing the special injury distinction between share dilution and voting power, the court noted:

> [The plaintiff did] not allege any stockholder dilution in relation to pre-merger voting rights. Instead, their claim of dilution is based on the merger exchange ratio, which was a necessary result of the purchase price for Bank One. ***Any alleged dilution was a harm suffered by all pre-merger JPMC stockholders and, consequently, JPMC itself***.[50]

But if the harm flowed to JPMC stockholders in the first instance, and only "consequently, JPMC itself," then the claim should be direct under *Tooley*'s first prong.[51] In what would become a recurring pattern in subsequent cases, the court viewed as significant the fact that the injury was shared by all stockholders instead of suffered by a small subset of stockholders. This harkens back to *Moran*'s oft-quoted formulation of "special injury" as one that is "separate and distinct from that suffered by other shareholders."[52] Indeed, *J.P. Morgan*'s—and subsequent decisions'—focus on distinguishing some from all stockholders in the equity dilution context may as well have come straight from *Elster*, the progenitor of "special injury":

> Plaintiff claims that the value of his stock will deteriorate and that his proportionate share of the stock will be decreased as a result of the granting and exercise of the stock options. Assuming plaintiff's contention is correct, this would apply to the stock of all other stockholders as well.[53]

---

[49] *SinglePoint*, 2003 WL 1240504, at *5 n.36.
[50] *In re J.P. Morgan*, 906 A.2d at 818 (emphasis added).
[51] *Id*.
[52] Moran v. Household Intern., Inc., 490 A.2d 1059, 1070 (Del. Ch. 1985).
[53] Elster v. American Airlines, 100 A.2d 219, 222 (Del. Ch. 1953).

The problem with this reasoning is that whether some stockholders suffered the injury as opposed to all stockholders is irrelevant under *Tooley*. What should matter is whether the stockholders suffered the harm and will recover damages, or the company. In fact, *Tooley* criticized one of the special injury cases for reasoning that "a suit must be maintained derivatively if the injury falls equally upon all stockholders."[54] This "concept," *Tooley* reasoned, is "inaccurate because a direct, individual claim of stockholders that does not depend on harm to the corporation can also fall on all stockholders equally, without the claim thereby becoming a derivative claim."[55] Consider a stockholder challenge to an all-cash merger involving a public, uncontrolled company wholly owned by disparate stockholders and alleging that defendants violated their *Revlon* duties by failing to accept the highest cash offer. All would agree that such claims are indisputably direct, yet the alleged harm was suffered by all pre-merger stockholders rather than just a subset.[56]

The *J.P. Morgan* court also criticized plaintiffs for being "unable to point to any authority under Delaware law that the direct/derivative analysis is affected by the form of consideration used in a transaction."[57] But *Tooley* was only a year old then. Plaintiffs would have been hard pressed to find ***any*** authority at this point under the new legal framework. *J.P. Morgan* only got around this issue by disregarding *Tooley*'s disavowal of special injury and drawing liberally from that corpus of cases.

To be clear, *J.P. Morgan*'s final outcome was surely correct. Plaintiffs challenged the business decision of independent directors of a public company for buying another entity at an unremarkable 14% premium. The court would have dismissed Defendants under Rule 12(b)(6) for failure to state a claim even if the court had determined that the suit was direct. As the court held, albeit under the heightened Rule 23.1 pleading standard, "[d]ue to the absence of particularized factual allegations calling into question the directors' good faith, honesty, or lack of adequate information," defendants were "entitled to the protection of the business judgment rule."[58]

But how the court got to that dismissal matters, as its reasoning for why an equity dilution claim should be derivative would be referenced frequently up to the present day with little by way of further analysis or questioning.

[54] Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1037 (Del. 2004).
[55] *Id.*
[56] *See, e.g.*, Brookfield Asset Mgmt., Inc. v. Rosson, 261 A.3d 1251, 1266-67 (Del. 2021) ("*Revlon* . . . provides for a direct claim"); *see also infra* Part IV.
[57] *In re* J.P. Morgan Co. S'holder Litig., 906 A.2d 766, 818 (Del. Ch. 2005).
[58] *Id.* at 825.

J.P. Morgan's re-injection of special injury-based reasoning into the corporate canon a year after its supposed ejection constitutes a significant asterisk to the *Tooley* test's exclusive application.

B. "Special Injury" Expands: Gentile and its Critics

A year after *J.P. Morgan*, in *Gentile v. Rosette*, Delaware courts doubled-down on the distinction the special injury test drew between share dilution and diminishment of voting power, and between harm to some stockholders versus all stockholders. *Gentile* plaintiffs alleged that SinglePoint Financial, Inc. issued an excessive number of new shares to a controlling stockholder in exchange for loan forgiveness, thereby diluting both their equity stake and voting power. But a subsequent merger liquidated SinglePoint, deprived plaintiffs of their SinglePoint stock, and, by extension, also deprived plaintiffs of their standing to assert derivative claims on SinglePoint's behalf.

J.P. Morgan had resuscitated pre-*Tooley* reasoning suggesting that share dilution is derivative while voting power diminishment is direct. The *Gentile* court relied on that same concept and drew from a series of pre-*Tooley* special-injury cases to recognize a "dual-natured" claim that stockholders can assert directly:

> 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 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.[59]

Gentile never adequately explained why equity dilution leads to "a separate,

[59] Gentile v. Rossette, 906 A.2d 91, 99–100 (Del. 2006) (citing Grimes v. Donald, 673 A.2d 1207, 1213 (Del. 1996); *In re Paxson*, 2001 WL 812028; Oliver v. Bos. Univ., 2000 WL 1091480 (Del. Ch. July 18, 2000); Turner v. Bernstein, 1999 WL 66532, at *11 (Del. Ch. Feb. 9, 1999)), *overruled by Brookfield*, 261 A.3d 1251.

and direct, claim" under *Tooley*.[60] Instead of conducting a *Tooley* analysis on whether equity dilution actually injured the company or the stockholder, the court relied on its pre-*Tooley In re Tri-Star Pictures, Inc*. decision.[61] *Tri-Star* had concluded that controller expropriation is direct under the special injury test: "plaintiffs allege that Coca–Cola used its influence as controlling shareholder, and its domination of the self-dealing board of directors, to orchestrate a master plan fully knowing that special injury would be suffered by the non-controlling stockholders of Tri–Star."[62] Following *Tri-Star*'s reasoning, *Gentile* stated that a direct claim exists because the public stockholders "are harmed . . . to the same extent that the controlling shareholder is (correspondingly) benefited."[63] That is the same focus on whether an injury is shared by all stockholders or only some stockholders that *J.P. Morgan* had adopted, and which originates from *Elster*.[64] In *J.P. Morgan*, all stockholders were diluted equally, so the court reasoned that the claim was derivative.[65] In *Gentile*, public stockholders were diluted while the controlling stockholder's stake grew, so the court instead found that there was a direct component to the claim.[66] But as already noted above, whether some or all stockholders suffer an injury should be irrelevant under *Tooley* and has bearing only under the purportedly defunct special injury test.[67]

Just like *J.P. Morgan*, proper application of the *Tooley* framework, unaffected by special-injury influence, to the facts in *Gentile* would have led to the holding that the equity dilution claims at issue were direct. *SinglePoint* was unharmed because, again, the new stock it issued was valueless to the company; meanwhile, the company benefited from loan forgiveness. The only injury accrued to the stockholders, who both lost voting power and found their individual shares in the company reduced on account of the alleged overpayment—even though the company's enterprise value was now enlarged.[68] In fact, the *Gentile* court also recognized that the only available remedy flowed to stockholders as the seller no longer existed; "The only available remedy would be damages, equal to the fair value of the shares

---

[60] *Gentile*, 906 A.2d at 100.
[61] *Id.* at 99, 101.
[62] *In re* Tri-Star Pictures, Inc., Litig., 634 A.2d 319, 326-327 (Del. 1993), *as corrected* (Dec. 8, 1993), and *disapproved of by* Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031 (Del. 2004).
[63] *Gentile*, 906 A.2d at 100.
[64] *See supra* Section II.A.
[65] *In re* J.P. Morgan Co. S'holder Litig., 906 A.2d 766, 818 (Del. Ch. 2005).
[66] *Gentile*, 906 A.2d at 100-01.
[67] *See supra* Section II.A.
[68] *See also infra* Section IV.A.

representing the overpayment by *Single Point* in the debt conversion. The only parties to whom that recovery could be paid are the plaintiffs."[69]

Gentile's ultimate conclusion was thus correct. But as with *J.P. Morgan*, the path there did not comport with *Tooley*. Instead of starting its analysis from *Tooley*'s blank slate, the court could not resist the pull of past precedent even though *Tooley* had expressly overruled the reasoning in those cases. As a result, *Gentile* only reinforced special injury concepts that had survived *Tooley* and were now lurking within Delaware's new derivative standing framework.

Gentile was extensively criticized by practitioners, academics, and jurists after the decision was issued; we will not recount that extensive corpus. Relevant here, in the December 2016 *El Paso Pipeline GP Company, L.L.C. v. Brinckerhoff* decision, the Delaware Supreme Court limited *Gentile* to its facts and confined dual-natured claims to the "unique circumstances" arising from "an improper transfer of both economic value ***and*** voting power from the minority stockholders to [a] controlling stockholder."[70] Then-Chief Justice Strine penned an oft-cited concurrence blasting *Gentile* as "a confusing decision, which muddies the clarity of our law in an important context," and suggested that *Gentile* should be overruled entirely. But the Chief Justice then urged a return to "traditional doctrine":

> To suggest that, in any situation where other investors have less voting power after a dilutive transaction, a direct claim also exists turns the most traditional type of derivative claim—an argument that the entity got too little value in exchange for shares—into one always able to be prosecuted directly.[71]

By then, the notion that dilution claims are derivative had been baked into the corporate canon despite its special injury antecedents. As Chancellor Chandler wrote in 2009, citing *Gentile* and *J.P. Morgan*, "[c]lassically,

[69] *Gentile*, 906 A.2d at 103.

[70] El Paso Pipeline GP Co., L.L.C. v. Brinckerhoff, 152 A.3d 1248, 1263-64 (Del. 2016). The *El Paso* plaintiffs challenged, as a breach of a limited partnership agreement, a November 15, 2010 transaction where a parent entity caused a limited partnership it controlled to purchase an asset from the parent entity at an inflated cash price. *In re* El Paso Pipeline Partners, L.P. Derivative Litig., 2015 WL 1815846, at *27 (Del. Ch. Apr. 20, 2015). Although cash overpayment is indisputably derivative, *see infra* Section IV.A., the plaintiff, as a limited partner and therefore a contractual party to the limited partnership agreement, could arguably sue to enforce certain provisions of that agreement directly. *In re* El Paso Pipeline Partners, L.P. Derivative Litig., 132 A.3d 67, 88 (Del. Ch. 2015), *rev'd sub nom. In re* El Paso, 152 A.3d 1248. The Court of Chancery held that the particular provision at issue gave rise to a dual-natured claim enforceable by stockholders. *Id.* at 112. The Supreme Court credited the Court of Chancery's "thoughtful opinion," but disagreed. *In re El Paso*, 152 A.3d at 1251.

[71] *In re El Paso*, 152 A.3d at 1266.

Delaware law has viewed as derivative claims by shareholders alleging that they have been wrongly diluted by a corporation's overpayment of shares."[72].

C. The Law Today on Equity Dilution Claims: Brookfield and Sheldon

In September 2021, the Delaware Supreme Court overruled *Gentile* in *Brookfield Asset Mgmt., Inc. v. Rosson*, a result foreshadowed by *El Paso* five years before and the steady drumbeat of criticism *Gentile* attracted.[73] *Brookfield* is currently dispositive law and holds that equity dilution claims are derivative in nature.

Plaintiffs in *Brookfield* challenged TerraForm Power, Inc.'s "private placement of common stock" to its controlling stockholder, Brookfield Asset Management, Inc., "for allegedly inadequate consideration."[74] Brookfield acquired TerraForm after plaintiffs brought suit, thereby depriving stockholders of derivative standing.

Overruling *Gentile*, the *Brookfield* court rightly points out *Gentile*'s special-injury origins. "Although *Gentile* does not expressly discuss the 'special injury' test, it creates confusion by heavily relying on *Tri-Star*'s analysis . . . . By expressly stating that it had 'applied' *Tooley* and *Tri-Star*, *Gentile* blurred *Tooley*'s clear rejection of the 'special injury' test."[75]

But at the same time, *Brookfield* leaves intact the default rule that equity dilution claims are "classically" derivative even though its underlying reasoning is—as demonstrated *supra* at sub-sections I.A. and B.—also based on "special injury" concepts. The *Brookfield* court reasoned that:

> If the Private Placement was for inadequate consideration, the worth of the stockholder's interest is reduced to the extent TerraForm was harmed -- as the Vice Chancellor put it, "a classic

[72] Green v. LocatePlus Holdings, Corp., 2009 WL 1478553, at *2 (Del. Ch. May 15, 2009); *see also, e.g.*, Carsanaro v. Bloodhound Techs., Inc., 65 A.3d 618, 657 (Del. Ch. 2013) ("This Court has struggled with how to interpret *Gentile* and its potential to undercut the traditional characterization of stock dilution claims as derivative."); *Feldman*, 956 A.2d at 656 (noting allegation that company "issu[ed] equity for inadequate consideration[] and that [plaintiff's] equity holdings in the company were thereby diluted," and then, citing pre-*Tooley* special injury cases, remarking that "[t]raditionally, then, the harm [plaintiff] alleges from these transactions fell upon the corporation rather than any stockholder individually"); *Oliver*, 2006 WL 1064169, at *16-17 (discussing *Gatz* and *J.P. Morgan* and holding that, "[u]nder *Tooley,* the harm alleged by the Plaintiffs was suffered by the corporation because it was the corporation in the Plaintiffs' scenario that issued its stock too cheaply").

[73] Brookfield Asset Mgmt., Inc. v. Rosson, 261 A.3d 1251 (Del. 2021).

[74] *Id.* at 1255.

[75] *Id.* at 1273-74.

> derivative claim." The alleged economic dilution in the value of the corporation's stock is the unavoidable result of the reduction in the value of the entire corporate entity, of which each share of equity represents an equal fraction. Dilution is a typical result of a corporation's raising funds through the issuance of additional new shares. As the court in *Gentile* recognized, normally such equal 'injury' to the shares resulting from a corporate overpayment is not equated to specific, individual harm to stockholders. Here, the economic and voting power dilution that allegedly harmed the stockholders flowed indirectly to them in proportion to, and via, their shares in TerraForm, and thus any remedy should flow to them the same way, derivatively via the corporation.[76]

A critical problem with this analysis is that *Brookfield* never explains how it is that "TerraForm was harmed," or how it suffered a "reduction in the value of the entire corporate entity." Rather, *Brookfield* assumes that corporate-held stock is an asset of the company that contributes to the company's enterprise value—an assumption that is rejected in the academic literature and by legal commentators.[77] Nor is it clear what *Brookfield* means when it refers to an "'injury' to the shares." As with the transactions challenged in *Gatz*, *J.P. Morgan*, *Gentile*, and the myriad other dilution cases, TerraForm itself did not get any smaller or otherwise "lose" anything when it issued new stock for inadequate consideration. On the contrary, Brookfield gave TerraForm $650 million in cash.[78] The entity's enterprise value has increased, not decreased.

Despite the absence of an entity-level injury, *Brookfield* concluded that "holding Plaintiffs' claims to be exclusively derivative under *Tooley* is logical and re-establishes a consistent rule that equity overpayment/dilution claims, absent more, are exclusively derivative."[79] The three cases *Brookfield* cited for this proposition all rely on *J.P. Morgan*—and by extension *J.P. Morgan*'s reliance on "special injury" concepts—to support the idea that equity dilution is derivative.[80] In fact, drawing from *J.P. Morgan*, *Gentile*, and *Elster*, *Feldman* repeated the idea that equity dilution is derivative because "all of a corporation's stockholders are harmed. . . .In

---

[76] *Id.* at 1266.
[77] *See infra* Section III.B.
[78] *Brookfield*, 261 A.3d at 1257-59.
[79] *Id.* at 1267.
[80] *Compare Brookfield*, 261 A.3d at 1267 n.67, *with Oliver v. Boston U.*, No. CIV.A. 16570-NC, 2006 WL 1064169, at *16-17 (Del. Ch. Apr. 14, 2006) (discussing *Gatz* and *In re J.P. Morgan*); Green v. LocatePlus Holdings, Corp., No. CIV.A. 4032-CC, 2009 WL 1478553, at *2 (Del. Ch. May 15, 2009) (citing *In re J.P. Morgan* and *Gentile*); and Feldman v. Cutaia, 951 A.2d 727, 732-33 (Del. 2008).

order to state a direct claim, the plaintiff must have suffered some individualized harm not suffered by all of the stockholders at large."[81] Ironically, *Brookfield* itself pointed out that *Tooley* had "expressly disapproved 'both the concept of "special injury" and the concept that a claim is necessarily derivative if it affects all stockholders equally.'"[82]

Brookfield's recommitment to categorizing dilution claims as derivative is unsurprising. Afterall, they have always been "classically" derivative. By overturning *Gentile*, *Brookfield* merely reverted Delaware law to the default rule. But *Tooley*'s second prong also factored into the outcome. The Complaint itself sought "rescissory damages on behalf of TerraForm" instead of direct compensation to stockholders.[83] The Supreme Court further theorized that "the remedy could be canceling the shares and allowing the corporation to sell them for fair value or requiring the acquirer to pay fair value for the shares."[84] This raises the question of how to determine when a claim is direct or derivative if the two prongs of *Tooley* point in different directions. To preface our analysis on this issue below, the first prong must control when the two prongs conflict.[85] Not only is standing at core a matter of injury, but looking at who receives the recovery is an inherently unreliable exercise because Delaware courts have wide discretion to fashion an appropriate remedy. Indeed, in *Gentile*, a very similar fact pattern, the recovery would have gone directly to stockholders because the seller no longer existed.[86]

The *Brookfield* court was also limited in its ability to reassess the status of equity dilution because the plaintiffs never argued that equity dilution injures only stockholders and not the entity. Instead, plaintiffs stood on *Gentile* and, in the alternative, claimed that "diminution of their voting power" is a direct harm.[87] But, of course, treating voting and economic rights differently comes from the special injury test.[88] And, in any event, the court held that plaintiffs' voting rights theory did not state a claim without reaching whether that claim was direct or derivative.[89]

Plaintiffs missed an opportunity in *Brookfield*. Indeed, there are

---

[81] *Feldman*, 951 A.2d at 733. Of course, *Brookfield* and *Gentile* both involved controlled transactions where not all stockholders shared in the dilution.
[82] *Brookfield*, 261 A.3d at 1264.
[83] *Id.* at 1266.
[84] *Id.* 1266 n.64.
[85] *See infra* Section III.C.
[86] *Gentile*, 906 A.2d at 103.
[87] *Brookfield*, 261 A.3d at 1280.
[88] *See supra* Sections II.A, II.B.
[89] *Brookfield*, 261 A.3d at 1281.

indicators that the Delaware Supreme Court could have been receptive to an argument that stock dilution does not inflict an entity-level injury. A year before *Brookfield*, in *Sheldon v. Pinto Technology Ventures, L.P.*, stockholders brought suit alleging that three venture capital firms with a "substantial proportion" of the firm's voting power caused the firm to raise $40 million by overpaying in stock, thereby diluting existing stockholders.[90] Plaintiffs lost derivative standing, however, when the company was later acquired.[91]

To get around the traditional rule that dilution claims are derivative, plaintiffs attempted to allege that the venture capital firms formed a control group, therefore entitling plaintiffs to press a dual-natured suit under *Gentile*.[92] The Court of Chancery held that there was no control group, thus no *Gentile*, and that plaintiffs therefore did not have standing.[93]

Plaintiffs appealed solely on the basis of whether a control group existed, but during oral argument before the Delaware Supreme Court, two of the Justices who would later decide *Brookfield* asked questions expressing skepticism about whether there was harm to the company. Just over a minute into plaintiffs' presentation, Justice Traynor asked: "[h]ave you made an overpayment claim in this case? And if you didn't, why are we viewing this case through the prism of *Gentile*?"[94] Plaintiffs' counsel must not have perceived that the Justice had offered him a way to establish standing without resort to *Gentile*, and answered by explaining why his claim fit within the equity overpayment paradigm—a "classically" derivative claim. A few minutes later, the Justice interrupted plaintiffs again to clarify the issue: "did the transaction have the effect of diminishing the value of the company, which is what happens in a corporate overpayment case?"[95] Counsel could have answered "no," and then pivoted to argue that their claim was direct under *Tooley*. But instead, counsel answered "yes" and returned to his *Gentile* analysis. Next, Justice Valihura—who would later author the *Brookfield* opinion—interrupted to ask whether plaintiffs' claim turned on the existence of a control group and remarked that, "I share Justice Traynor's puzzlement as to exactly where the corporate-level overpayment is pled."[96]

---

[90] Sheldon v. Pinto Technology Ventures, L.P., 220 A.3d 245, 248-50 (Del. 2019).
[91] *Id.* at 250.
[92] *Id.*
[93] *Id.*
[94] Oral Argument at 1:25, *Sheldon v. Pinto Technology Ventures, L.P.*, C.A. No. 81, 2019. (Del. Sept. 11, 2019), https://courts.delaware.gov/supreme/oralarguments/download.aspx?id=3192, [https://perma.cc/MUA9-B2UJ].
[95] *Id.* at 3:36.
[96] *Id.* at 8:35.

Plaintiffs' befuddlement, however, was shared by defendants, who misunderstood the court's questioning to suggest that the stock issuance was not excessive, and opened their argument by agreeing that plaintiffs had not alleged an overpayment claim. Seizing on this, Justice Traynor asked: "If there was no overpayment alleged . . . what is the derivative nature of the claim? What is the harm to the company if there was no overpayment?"[97] Justice Traynor's and Justice Valihura's line of questioning was correct. There was no "corporate-level overpayment"; the overpayment was at the stockholder level. But that is true for all equity dilution claims.

The court ultimately agreed with the Court of Chancery that no control group existed and affirmed the dismissal of the case. In a footnote, the court noted that it had asked both parties during oral argument "whether a 'classically derivative' dilution claim arising from an overpayment was actually pled," and whether "the *Gentile* prism" even applied—but "because those issues (including what, if any, effect the absence of an overpayment claim should have on the direct versus derivative analysis under *Tooley*) were not appealed or briefed, we decline to review them."[98]

Despite the potential opening in *Sheldon*, *Brookfield* has now even more firmly entrenched the "classical" view that equity dilution claims are derivative in Delaware law. As briefly described above, this rule is not consistent with *Tooley* and is in fact a holdover from the discarded special injury framework. In the Section that follows, we apply *Tooley* to equity dilution claims and examine in more detail why it is that issuing equity for inadequate consideration does not create any entity-level harm and injures only the stockholders.

III. APPLYING *TOOLEY* TO EQUITY DILUTION CLAIMS

As discussed above, although *Brookfield* overruled *Gentile* to align Delaware law with "*Tooley*'s simple analysis[,]"[99] it accepted *Gentile*'s assessment that, if there is "an overpayment (or 'over-issuance') of shares" to a controller, the corporation is harmed and "has a claim to compel the restoration of the value of the overpayment."[100] That statement, however, does not hold up under *Tooley*. In this section, we introduce the analogy of the corporate pie to help understand how the *Tooley* framework separates direct from derivative. We then apply the *Tooley* test to equity dilution to

[97] *Id.* at 21:55.
[98] *Sheldon*, 220 A.3d at 250 n.15.
[99] Brookfield Asset Mgmt., Inc. v. Rosson, 261 A.3d 1251, 1276 (Del. 2021).
[100] *Id.* at 1266; Gentile v. Rossette, 906 A.2d 91, 100 (Del. 2006).

demonstrate why it is that such claims are properly direct, and how equity dilution harms stockholders but not the entity. We also point out that the outcome of applying *Tooley*'s second prong is case-dependent, and that when *Tooley*'s prongs conflict, the first must predominate.

A. Understanding Tooley: The Corporate Pie

Tooley is easier to understand by comparing an entity's total value to a pie. When the corporation's value increases, the pie expands radially—an 8-inch pie becomes a 12-inch pie. When the corporation's value decreases, the pie shrinks radially—an 8-inch pie becomes a 6-inch pie. Each stockholder owns a percentage of that value, proportional to their stock ownership of the corporation—that is their "slice" of the pie.[101] When stockholders buy or sell shares, their "slices" of the pie get wider or narrower in lockstep. And, of course, if a company loses value, the whole pie shrinks radially and everyone's slices lose volume proportionally. Importantly, changes to the size of the pie and/or the individual slices do not necessarily constitute legally cognizable harm. For a claim to arise, there must be misconduct—a breach of fiduciary duty or otherwise—that causes the pie or individual slices to shrink.

Applying the pie analogy, *Tooley*'s first prong (who has been harmed?) asks whether wrongdoing has shrunk the whole pie, or whether only individual slices have shrunk despite growth or no change to the whole pie. If wrongdoing shrinks the whole pie, then the company as a whole has been injured and the claim is derivative. Stockholders suffer only indirectly, as each of their slices shrink proportionately with the rest of the pie; hence, the familiar maxim that, "[w]here all of a corporation's stockholders are harmed and would recover *pro rata* in proportion with their ownership of the corporation's stock solely because they are stockholders, then the claim is derivative in nature."[102]

Consider, for example, an ordinary corporate transaction. The company uses cash to buy real estate. If the real estate's fair value is equivalent to the cash paid, the company's pie remains the same; the outflow of cash is equal to the inflow of the value of the real estate. Suppose the company later discovers that there is a previously undiscovered diamond vein under the purchased real estate. The land's value is actually much higher than what the

---

[101] Where economic ownership and voting rights are separate or not proportional, the analogy still stands, though the pie for economics and the pie for voting rights will differ.

[102] Sciabacucchi v. Liberty Broadband Corp., 2018 WL 3599997, at *7 (Del. Ch. July 26, 2018) (quoting *Feldman*, 951 A.2d at 733).

company paid in cash; the inflow of real estate value is greater than the outflow of cash, so the pie grows, and the stockholders' shares are worth more. Now imagine the reverse; the seller told the company that it had reason to believe that there is a diamond vein under the land, but the company discovers after closing the deal that the vein had already run dry. The company would have overpaid for the real estate; the inflow of real estate value is less than the outflow of cash. The pie shrinks and the stockholders' shares are worth less. The shrinking of the pie does not give rise to a claim unless the seller's representation to the company was wrongful—for example, if the seller purposefully misrepresented that the diamond vein had not yet run dry. If such a claim exists, however, it clearly belongs to the company.

Conversely, when wrongdoing changes the size of individual pie slices but the whole pie either stays the same size or gets bigger, the resulting claim is direct and belongs to the stockholders. For example, suppose a 30% stockholder sells her shares to a 20% stockholder. Any wrongdoing related to that transaction does not involve the company or its value—the whole pie—and is strictly between the two stockholders. Put another way, entity value does not depend on how the pie is cut and who owns what proportion; it is entirely independent of the machinations of the various stockholders in increasing or decreasing the relative volume of their slices. The whole pie does not change in size. Any change in ownership percentages—unless it impacts the size of the total pie—must therefore be direct. This comports with *Tooley*'s instruction that "[t]he stockholder's claimed direct injury must be ***independent*** of any alleged injury to the corporation."[103]

Put another way, picture a physical and perfectly round apple pie, cut into differently sized slices. Derivative claims, because they involve harm to the company, cause the pie as a whole to shrink radially. Picture centering a large, round cookie cutter over the pie, and using it to cut off the crust. All of the slices shrink because their crusts have been cut off. But the pie was damaged first—the owner of each slice is harmed only indirectly because the whole pie has lost its crust. That is a derivative claim.

Direct claims arise when the pie has not shrunk, but wrongdoing has redistributed or affected the owners' rights to their individual pie slices. Perhaps the board forced stockholders to sell their slices for too low a price. Or a controlling stockholder has cut a piece from someone else's slice and claimed that piece for itself. Maybe an outside investor has added more apple filling to the pie—i.e., paid the company consideration—in exchange for a

[103] Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1039 (Del. 2004) (emphasis added).

slice of the whole, but instead of giving her a slice proportionate to her contribution, the board gives her too large a slice. If the whole pie gets fatter from the added filling or remains the same size, but you need more slices, the only way to do so is by cutting some from the other slices. Although the stockholders may find giving up a fraction of their slices acceptable when the consideration paid in return is fair, too little consideration would give rise to a claim. And that claim is direct because the pie has not gotten smaller.

One can use the pie analogy to determine whether a claim is direct or derivative in different ways. One way is by asking whether wrongdoing has shrunk the whole pie. If not, the claim is direct. Another way is by asking which side of the plaintiffs' slices have been cut off. If the slices shrank from the crust-sides, the claim is derivative because damage accrued to the whole pie. But if the slices shrank because someone has shaved pieces off the sides, that claim is direct.

B. Tooley Prong One: Equity Dilution Harms Only Stockholders and Not the Entity

As a refresher, *Tooley*'s first prong asks "who suffered the alleged harm (the corporation or the stockholders, individually)?"[104] Equity dilution does not harm the entity. It harms only stockholders.

Issuing stock cannot on its own "harm" an entity—at least in the manner that *Tooley* uses that phrase—because stock is valueless and contributes nothing to the entity's value when held by the entity itself. A company is not worth more because it holds its own (treasury) stock or is authorized to issue more ("authorized" or "non-issued") stock, and it is not worth less if it gives out that stock for free.[105] Consider two corporations, identical in all aspects except that one's charter authorizes it to issue 10,000 shares of stock, whereas the other's charter authorizes it only to issue 100 shares of stock. The first corporation is not more valuable than the second.[106] If it were, boards could increase corporate value simply by amending the charter to authorize more stock. And as for voting rights, 8 Del. C. § 160(c) bars

---

[104] *Tooley*, 845 A.2d at 1033.

[105] Treasury and authorized stock are technically different. The former refers to stock that the entity holds after re-purchasing previously issued stock from stockholders. The latter refers to stock that has been authorized by the charter but has not been issued. That technical difference does not matter here as neither are held outside the entity and we refer to authorized and treasury stock interchangeably.

[106] If anything, the second corporation may be "worth" more to its stockholders because the potential for dilution is more limited. But as to third parties, the two entities have the same value.

companies from voting their own stock or that of their controlling stockholder.

The fact that authorized and treasury stock are valueless to the company is well-established in academic literature.[107] In law, as one New York appellate court noted, treasury stock "is not considered as an asset of the corporation," "has no value," and "[t]heir existence as issued shares is a pure fiction":

> Treasury stock, as such, is not considered as an asset of the corporation. It is only what is received in consideration of its reissuance that is considered an asset of the corporation. The Treasury stock in and of itself while held by the corporation has no value, and so "Treasury shares carry no voting rights or rights as to dividends *or distributions*. Their existence as issued shares is a pure fiction, a figure of speech to explain certain special rules and privileges as to their reissue."[108]

Adjudicating a tax dispute, Judge Learned Hand once described the idea that unissued or treasury "shares have an existence as such, and are more than a mere power to issue shares," as a "mistaken supposition" and "unsound."[109] Judge and former SEC Chairman Jerome Frank "th[ought] it irrational ever to consider 'treasury stock' as a capital asset."[110]

These conclusions should be unsurprising; after all, shares of stock are mere proxies for a company's economic value and are not themselves worth anything independent of the portion of the entities they represent. Because treasury and authorized stock carry no attendant rights and therefore no value until the moment they are issued, the company does not bear the costs of issuing stock even though it is the recipient of any benefit. Equity issuances thus do not transfer value from the entity. Instead, they redistribute existing stockholders' economic and voting rights in the entity to new or other stockholders. It follows, then, that overpaying stock for inadequate

---

[107] *See, e.g.*, J.C. Ray, *Accounting for Treasury Stock*, 37 ACCT. REV. 753, 753 (1962) ("Even so, treasury stock is generally considered *not* an asset. This conclusion is based on the fact that the issuing corporation does not acquire the rights usually inherent in stock ownership. Such rights include voting, participation in dividends and liquidations, and the pre-emptive right."); L. L. Briggs, *Treasury Stock and the Courts*, 56 J. ACCT. 171, 173, 197 (1933) ("According to the English view, if a company give a shareholder anything in return for his stock, the corporation's capital, in the sense of assets, is reduced"; "For financial purposes treasury stock has the same status as if it had been retired.")

[108] Christie v. Fifth Madison Corp., 13 A.D.2d 43, 51 (N.Y. App. Div. 1961) (quoting *Ballantine on Corporations* at 615).

[109] E.R. Squibb & Sons v. Helvering, 98 F.2d 69, 70-71 (2d Cir. 1938), *modified*, 102 F.2d 681 (2d Cir. 1939).

[110] Comm'r v. Batten, Barton, Durstine & Osborn, 171 F.2d 474, 477 (2d Cir. 1948).

consideration inflicts injury on stockholders. Again, setting aside the transaction costs attendant to any transaction,[111] an entity could issue shares for free without affecting its enterprise value. So, when boards issue stock, stockholders pay while the company pays nothing. And when the company gets too little for its shares, the stockholders paying the bill are harmed.

The strongest rebuttal in favor of treating dilution claims as derivative is that the company can at least sell treasury and authorized stock for consideration. So, accepting lower payment for stock when the company could have pressed for a higher price inflicts an entity-level opportunity cost. But *Tooley*'s first prong asks "who suffered the alleged *harm*" from a challenged transaction, not who gets the *benefit*.[112] And while the redistribution of economic and voting rights from one stockholder to another clearly inflicts an individualized injury, the company's opportunity cost is as much a measure of the company's potential upside as it is a cost. Here, opportunity cost is the same as lost profit. A micro-economist would tell us that, quantitatively, lost profit is still a loss, but qualitatively, it is not clear whether *Tooley*'s reference to "harm" includes lost profits.

Tooley does not explicitly say. But there are at least four reasons why lost profit does not constitute a "harm" under *Tooley* and thus does not justify treating dilution claims as derivative. ***First***, even if one accepts that opportunity cost accrues to the entity, that does not erase the separate injury to stockholders caused by a redistribution of their economic and voting rights—an injury that does not affect corporate value. At most, then, this would give rise to a dual-natured claim. Derivative actions are a "creature of equity;" they "grant . . .equitable standing to a stockholder" and serve "as a vehicle to enforce a corporate right."[113] There is no law[114] suggesting that such an instrument, designed only to enable stockholders to enforce rights on behalf of another, could then be turned on the stockholder to eliminate their ability to recover for *their own* injury, an injury that is distinct from any corporate harm. Indeed, as Chief Justice Strine stated in *NAF Holdings, LLC* v. *Li & Fung (Trading) Ltd.*, "[r]eading *Tooley* to convert direct claims belonging to a plaintiff into something belonging to another party would, we

[111] Transaction costs alone, without alleged attendant wrongdoing, cannot constitute a derivative injury. Otherwise, every litigation involving a merger or other significant corporate transaction would be at least partially derivative, because the company always incurs transaction costs in negotiating, executing, and closing a deal. That does not mean, for example, that a target company's stockholders cannot directly challenge a merger if they did not receive fair value for their shares.

[112] Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1033 (Del. 2004).

[113] Schoon v. Smith, 953 A.2d 196, 202 (Del. 2008).

[114] None, that is, that the authors are aware of.

confess, be alien to our understanding of what was at stake in that case, or in the cases after *Tooley* that relied on it."[115]

Second, lost profit is not a standalone entity-level injury; its very value derives from an injury to stockholders. The entity's profit from a sale of equity derives from a third party's valuation of and willingness to purchase the equity's attendant economic and voting rights—rights that reciprocally diminish the existing stockholders' rights. In other words, the stockholders are funding the entity's profit with their proportionate shares of the company. *Tooley* suggested that a stockholder can only bring a direct claim if "he or she has suffered an injury that is not dependent on an injury to the corporation."[116] This suggests that a reciprocal rule may also apply: a claim is derivative only if the entity has suffered an injury that is not due to an injury to stockholders.

In fact, rule reciprocity, and the treatment of dilution claims as direct, is vital to avert a moral hazard. That is because—***third***—lost profit does not capture the full range of injury from equity dilution. The highest possible opportunity cost to the company is the difference between the maximum price a third party is willing to pay for the equity and zero. The company's existing enterprise value acts as a floor; no amount of overpayment in stock will ever cause that enterprise value to drop. But the stockholders who are ultimately paying for the issuance with their economic and voting rights have no floor for their potential loss; the more stock the company issues, the more harm they suffer. They stand to lose not only their pro-rata share of the maximum possible consideration, but also their pro-rata share of the entity's enterprise value. That is because corporate fiduciaries concerned solely with maximizing corporate value would simply keep issuing more shares until that stock was worthless. If the entity has received a poor deal, what of it? There is no such thing as a poor deal for the corporation in issuing equity so long as it gets the best possible price. In other words, the entity's interest is not aligned with that of stockholders because the entity cares only about enterprise value and not about the distribution of that value. Opportunity cost therefore fails to capture the full range of "harm" from dilution because it is a metric only for the company's lost profit and does not measure stockholders' full exposure when stockholders are paying the bill.

Fortunately, entities are not animate. They are directed by corporate fiduciaries who are charged with fulfilling fiduciary duties, not only to the

---

[115] NAF Holdings, LLC V. Li & Fung, 118 A.3d 175, 180 (Del. 2015) (holding that *Tooley* does not bar contractual parties from enforcing their own contracts directly merely because the breach harms only a third-party beneficiary).

[116] *Tooley*, 845 A.2d at 1036.

entity, but to stockholders. There are two policing mechanisms for ensuring that those fiduciaries do their job—corporate democracy and litigation. But corporate democracy itself is undermined by unfair equity issuances; share dilution typically redistributes voting rights from existing stockholders. In the extreme hypothetical above, a company seeking to maximize its own value without regard to distribution would dilute existing stockholders until their shares become immaterial. In a more realistic example, a controlling stockholder can entrench itself by causing the board to issue it a substantial sum of stock. Additionally, equity dilution often takes the form of transactions that do not require a stockholder vote, such as acquisitions funded by stock issuances. That means litigation must do extra work because the efficacy of the corporate franchise in regulating dilutive transactions is reduced. Attributing such a claim to the company would be misguided given the misalignment between stockholder and entity interests. Where only stockholders bear the full cost, stockholders should be empowered to protect those rights.

Finally, recognizing opportunity cost as an entity-level "harm" under *Tooley* also has nonsensical implications. As a company can only convert treasury and authorized stock into value upon sale, a company that fails to exchange available treasury or authorized stock for non-zero consideration potentially realizes an opportunity cost—one that compounds due to the time of value of money until that stock is sold and converted into cash that the company can reinvest. If that is "harm," then the company's *failure* to periodically sell its treasury or authorized stock could constitute injury for standing purposes.

In short, equity dilution is direct under *Tooley*'s first prong. The corporate pie shorthand yields the same conclusion. When corporate fiduciaries issue stock in exchange for cash, the whole pie gets bigger so long as the company gets paid something, no matter how little. Just a dollar added to the pie produces a bigger pie. But while the pie as a whole is undamaged, a stock issuance recuts the slices owned by some or all of the existing stockholders so that they are thinner, and then redistributes the pieces cut to others. This redistribution affects stockholders only.[117]

The pie analytic also suggests a fifth reason for why opportunity costs do not constitute "harm" under *Tooley*—saying so is simply counterintuitive

[117] *See also infra* Section IV.A. (discussing implications of direct dilution claims by applying the pie paradigm).

and an alien use of a common phrase.[118] Even if corporate fiduciaries sold stock to add two apples to the pie when they could have demanded five apples, the pie itself is still whole and in fact has grown—it has not suffered three apples worth of "harm," "injury," or "damage." Courts give "words their commonly understood meanings."[119] In that sense, "harm" likely refers only to actual, out-of-pocket injury rather than something so arcane as opportunity cost.

C. Tooley Prong Two: What if the Prongs Conflict?

Tooley's second prong asks "who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?"[120] This is not as simple a question as the *Tooley* court likely intended, as who recovers in a dilution claim depends on the fact pattern and the court's choice of recovery. There is a real possibility that *Tooley*'s two prongs may point in different directions. For the reasons below, the first prong must control in the event of conflict.

Consider the transactions in *Gentile* and *Brookfield*, which were substantially indistinguishable in structure, but for which the court proposed different remedies.[121] In *Gentile*, the seller was first insolvent and then ceased to exist, so "the only available remedy would be damages" to the stockholders.[122] The court in *Brookfield*, on the other hand, advanced several possible remedies. Plaintiffs "s[ought] rescissory damages on behalf of" the company, while the court suggested that "the remedy could be cancelling the shares and allowing the corporation to sell them for fair value or requiring the acquirer to pay fair value for the shares."[123]

The stockholder cash recovery *Gentile* proposed points to a direct claim. The *Brookfield* plaintiffs' request for rescissory damages (i.e., cash) to the company clearly points to a derivative claim. Requiring the acquirer to pay fair value is also a derivative recovery—the acquirer must pay the company more cash for the purchased shares. However, cancelling the shares

[118] Black's Law Dictionary unhelpfully defines "harm" as "[i]njury, loss, damage; material or tangible detriment." *Harm*, BLACK'S LAW DICTIONARY (11th ed. 2019). The definition for "injury" adds that "harm denotes any personal loss or detriment." *Injury*, *Id.*
[119] Kofron v. Amoco Chemicals Corp., 441 A.2d 226, 230 (Del. 1982).
[120] *Tooley*, 845 A.2d at 1033.
[121] In re TerraForm Power, Inc. S'holders Litig., 2020 WL 6375859, at *11 (Del. Ch. Oct. 30, 2020) ("The facts alleged in the Complaint fit Gentile's transactional paradigm to a T."), *rev'd sub nom. on other grounds, Brookfield*, 261 A.3d 125.
[122] Gentile v. Rossette, 906 A.2d 91, 103 (Del. 2006).
[123] Brookfield Asset Mgmt., Inc. v. Rosson, 261 A.3d 1251, 1266 n.64 (Del. 2021).

or otherwise returning the shares to the company only appears derivative on first blush, and is actually direct. That is because the moment the shares are cancelled or returned, the stockholders benefit, but the shares cease to have any value to the company. Recall that authorized and treasury stock are valueless unless issued, so the company is getting nothing back when a court unwinds an issuance.[124] In that situation, the only value transfer that occurs is the return of economic and voting rights represented by the cancelled or returned stock to the original stockholders.

The Delaware Supreme Court has contemplated all four of these possibilities as potential remedies for wrongful dilution, yet two accrue to stockholders while the other two accrue to the company. Therefore, regardless of whether one agrees with us that equity dilution exclusively harms stockholders, *Tooley*'s two prongs will point to different answers depending on what remedy the court chooses. That is unsurprising, as Delaware courts have "broad discretion in fashioning [] remedies" for "breaches of fiduciary duty."[125]

But this is also why *Tooley*'s first prong must control in the event of conflict. *Tooley* would be entirely unworkable if the owner of the claim—and whether a plaintiff must plead with particularity and satisfy Rule 23.1's requirements for pleading a derivative claim—is determined based on a variable that changes from case to case according to the court's discretion. Moreover, derivative standing is a "threshold issue,"[126] and remedies are not decided until after trial, at the very end of litigation.

Prioritizing the first prong over the second also makes sense as a matter of first principles. Distinguishing derivative from direct claims is an issue of standing, and federal courts determine standing based on whether a litigant has suffered an "injury in fact."[127] So too do Delaware courts, which "apply" the federal "concept of standing as a matter of self-restraint to avoid the rendering of advisory opinions at the behest of parties who are 'mere intermeddlers.'"[128] Equity may have carved out the derivative claim exception to allow stockholders to sue on behalf of the companies they own,

[124] *See supra* Section III.B.
[125] Ravenswood Inv. Co. v. Est. of Winmill, No. CV 3730-VCS, 2018 WL 1410860, at *2 (Del. Ch. Mar. 21, 2018) (finding liability for an "overly-generous" grant of stock options yet awarding only a declaratory judgment and nominal damages because, "[a]fter a decade of litigation, Plaintiff has failed to develop any evidence supporting cancellation, rescission, rescissory damages or some other form of damages as possible remedies for the proven breaches of fiduciary duty"), *as revised* (Mar. 22, 2018), *aff'd*, 210 A.3d 705 (Del. 2019).
[126] *Brookfield*, 261 A.3d at 1262.
[127] Dover Hist. Soc'y v. City of Dover Plan. Comm'n, 838 A.2d 1103, 1110 (Del. 2003).
[128] *Id.* at 1111.

but standing (and, by extension, derivative standing) nevertheless turns on injury, not recovery.

The *Tooley* test is thus double-pronged only superficially. In reality, the first prong is the actual analytical instrument, while the second acts only as a corroborative check. Delaware courts often treat the second prong as an afterthought.[129] Indeed, *Tooley* itself appears to recognize that the second prong is merely an appendage of the first: "We believe that this approach is helpful in analyzing the first prong of the analysis: what person or entity has suffered the alleged harm? The second prong of the analysis should *logically follow*."[130]

In the dilution context, the likelihood of a conflict between *Tooley*'s two prongs is not insignificant in light of the variety of possible remedies that *Brookfield* and *Gentile* identified, of which some are direct and others derivative. Because prong one should control and dilution exclusively damages stockholders, equity dilution claims should be treated as direct even in a case where, for whatever reason, the potential remedy flows to the company.

IV. APPLYING THE CORPORATE PIE; EXAMPLES OF DIRECT VERSUS DERIVATIVE SUITS

The previous section established that equity dilution claims are direct, because stock held by the company is valueless, and introduced the corporate pie analogy as a tool to ease *Tooley*'s application.[131] With the aid of the corporate pie shorthand, this last section discusses the implications of treating such stock as valueless, until sold, in different transactions. Thus far, we have only applied the corporate pie to single classes of stock, where voting and economic rights are allocated in lockstep. Before continuing with our application of the pie to transactions, then, we must first address situations involving multiple classes of stock that split economic and voting rights—a not uncommon occurrence.

---

[129] *See, e.g.*, *Brookfield*, 261 A.3d at 1266 (devoting two sentences and a footnote to prong two analysis); *In re J.P. Morgan*, 906 A.2d at 817–19 (extensive prong one analysis and two-paragraph prong two analysis where the court concluded that the remedy must flow to stockholders because "JPMC suffered" the harm); *Feldman*, 956 A.2d at 659–60 (concluding that dilution claim was derivative under prong one without conducting prong two analysis). *But see* In re MultiPlan Corp. S'holders Litig., 268 A.3d 784, 803 (Del. Ch. 2022) (conducting extensive prong two analysis).

[130] Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1036 (Del. 2004).

[131] A visual representation is not new to the law; the bundle of sticks analogy in property law is one example.

After clarifying the pie analogy in split rights situations, we proceed by applying the corporate pie to transactions solely involving stock—e.g., stock repurchases. We also briefly note that recognizing dilution as a stockholder injury reconciles the law on equity dilution with that on poison pills, which are dilutive transactions that Delaware law already recognizes as direct. We then consider the implications of mixed consideration—when the company pays in both stock and cash, and forms of payment that can be in either stock or cash (e.g., the convertible note). In such situations, *Tooley* necessitates the existence of dual-natured claims, which we posit raise no practical issues with implementation. The Article concludes by applying the corporate pie to common causes of action litigated before the court of Chancery.

A. Split Rights

Our discussion thus far has assumed only one class of stock, which carries both voting and economic rights. But corporations sometimes issue stock that splits those rights.[132] For such cases, imagine two pies: one for voting rights and one for economic rights.[133] The economic rights pie as a whole represents the company's enterprise value; upon liquidation, the economic rights holders split the value of the whole pie. By contrast, the voting right pie serves as a proxy that tracks the stockholders' division of the total vote.

Consider a corporation that has Class A and Class B stock. Class A stock has one vote per share, Class B stock has five votes per share, and the classes have equal economic rights. There is one Class B stockholder and there are three Class A stockholders. Because the four stockholders have equal economic rights, the economic rights pie is split into four equal slices of 25%. The voting rights pie, however, is split unequally: the Class B stockholder owns five of eight total votes, or 62.5%, and the Class A stockholders each own one of eight total votes, or 12.5%.

---

[132] *See, e.g.*, United Food & Com. Workers Union v. Zuckerberg, 250 A.3d 862 (Del. Ch. 2020) ("At Zuckerberg's request, the Facebook board of directors (the 'Board') pursued a reclassification of Facebook's shares. The transaction involved authorizing a new class of non-voting stock, then issuing two shares of non-voting stock to each existing stockholder. The effect of the reclassification would be to shift two-thirds of Facebook's economic value into the non-voting stock. The chief beneficiary was Zuckerberg, who would be able to transfer the bulk of his economic ownership in Facebook without giving up voting control."), *aff'd*, 2021 WL 4344361 (Del. Sept. 23, 2021).

[133] One can picture two pies for a company with only one class of stock also, but because the pies should behave identically (with the exception that the voting rights pie as a whole can neither get bigger nor smaller, since it doesn't represent corporate value), the exercise is usually redundant.

When this company overpays in cash, the harm is first to the company. The value of the company goes down, because the cash outflow exceeds the value of the asset it purchased. In our pie analogy, the whole economic rights pie shrinks, and the four stockholders' economic rights are equally harmed by shrinkage from the crust side of their slices. That claim is derivative both under *Tooley*'s first prong and under *Tooley*'s second prong, because recovery would restore the whole pie to its original size. There is no direct stockholder injury because (a) the slices of the economic rights pie have shrunk only due to the shrinking of the whole pie, and (b) the slices of the voting rights pie remain exactly the same.[134]

When the company overpays in stock, however, stockholders are injured. Suppose the company overpays by issuing a single Class A stock in return for a peppercorn of insufficient value. The economic pie as a whole expands ever so slightly because of that nominal value. The four pre-existing stockholders, however, have each had their pie slices narrowed, from 25% to 20% slices, to make room for a fifth stockholder. Although the original four slices are now ever so slightly longer because the pie is bigger by a peppercorn, the increased length does not make up for the narrowing of each slice.

Moreover, the voting pie has also changed. The Class B stockholder now owns five of nine votes, or 55.5%. The three pre-existing Class A shareholders now each only have 11.1%, or one of nine votes. Of course, the whole voting pie has not (and can never) shrink, as it serves only to track the division of the votes. And because the slices in the economic and voting pies have narrowed, the overpayment claim is direct.[135] Indeed, all situations where slices of the voting rights pie undergo change will give rise to direct rather than derivative claims precisely because the distribution of voting rights has no bearing on enterprise value. This is the same conclusion we arrived at in Section III.B.[136]

Acknowledging the direct nature of dilutive injury also reconciles an

---

[134] We note, however, that just because there is no harm to voting rights does not mean that such harm is required for direct claims. As established in Section III.B., stock dilution harms stockholders. A stockholder whose stock grants *no* voting rights can still bring direct claims if his slice of the economic pie has narrowed, through issuance of economic-rights stock, rather than shrunk from the crust side of the slice, due to overpayment in corporate assets.

[135] We note again that a narrowing of slices in *both* pies is not necessary for a direct claim. *See supra* note 134.

[136] The analysis is the same if Class B stock—which carries more votes—is sold. The economic dilution is the same as in the sale of Class A stock, as the two classes are worth the same share of the economic pie. But the existing stockholders have lost an even greater proportion of the voting rights pie to an incoming stockholder.

inconsistency in the caselaw. Voting rights belong to stockholders, not the company.[137] Yet both pre and post-*Tooley* cases have subordinated the stockholder's right to vote to economic rights whenever "overpayment" is involved[138]—hence *Singlepoint*'s remark that only "dilution claims *emphasizing* the diminishment of voting power have been recognized as direct claims."[139] But courts need not choose between competing harms to voting and economic rights. The answer is simpler, as both harms accrue to stockholders and are direct.

B. Tooley's Dependence on the Form of Consideration: Stock Repurchases, Stock Issuances (Poison Pills), Mixed Consideration, and Convertible Notes

Transactions in stock take many forms. Some are straightforward, while others are more involved. One is positively byzantine. In all cases, however, the form of consideration is vital to *Tooley*'s analysis.[140]

Stock Repurchase. When a company repurchases stock from its stockholders, the stock is taken out of circulation, loses its attendant voting and economic rights, and is converted into treasury stock. The outflow of cash (or whatever other asset is distributed in exchange[141]) shrinks the corporate pie. Meanwhile, the influx of stock, now treasury stock, does not expand the pie because treasury stock has no value to the company. The pie has shrunk, and the company purchased nothing of any value to it. Yet stock buybacks at a fair price are neither waste under corporate law principles nor disapproved of by stockholders—quite the opposite. This is because

---

[137] *In re* MultiPlan Corp. S'holders Litig., 268 A.3d 784, 802 (Del. 2018) ("Delaware courts regard 'a wrongful impairment by fiduciaries of the stockholders' voting power or freedom' as causing 'a personal injury to the stockholders, not the corporate entity.'").
[138] *See generally supra* Part II.
[139] Gentile v. SinglePoint Fin., 2003 WL 1240504, at *5 n.36 (Del. Ch. Mar. 5, 2003) (emphasis added). This is also why poison pills are today treated as direct even though they are dilutive. *See infra* Section IV.B.
[140] Although outside the scope of this Article, which focuses on *Tooley*'s doctrinal application, it bears mention that there are good policy reasons for why the nature of a claim should change based on the form of deal consideration. For one, treating stock dilution claims as derivative in the same manner as cash overpayment, despite the existence of direct injury to stockholders and the absence of any injury to the entity, deprives stockholders of a legal right to which they would otherwise be entitled. Further, unless a transaction occurs in a perfectly efficient and liquid public market, cash and stock are not the same even when they have the same implied monetary value.
[141] When the company pays in the equity of another entity, that equity is considered an asset, just like cash. Overpayment in such equity would be derivative, because, unlike the company's own equity, third-party equity comes with attendant voting and economic rights.

buybacks shrink the whole pie but widen the slices owned by each remaining stockholder. Assuming a fair transaction price, stockholders are not injured[142] because those who have been cashed out received equivalent compensation while the remaining stockholders are in the same position as before, holding wider slices of a smaller pie that are of unchanged volume.

When the corporation overpays for repurchased stock, however, the resulting claim is, of course, derivative.[143] A cash payment shrinks the whole pie (from the crust end). Remaining stockholders' slices get wider in a stock repurchase, but not enough to make up for their reduced length.

The Poison Pill. As we discuss at length above, a dilutive stock issuance should give rise to a direct claim under *Tooley*, even though "classical" Delaware law treats such claims as derivative. But stock issuances come in many guises. The stockholder-rights plan, or "poison pill," is one of them. Created to deter hostile takeovers, the poison pill comes in two forms. "'[F]lip-in' poison pills enable shareholders of the target—other than the acquirer and its affiliates—to purchase additional shares in the target for less than their actual value" once the would-be acquirer reaches a certain percentage ownership over the target.[144] "'Flip-over' poison pills are similar to 'flip-in' poison pills, except that instead of enabling shareholders of the target . . . to purchase target stock at below-market prices, they enable shareholders to purchase stock in an acquiring company upon the merger of the target into the acquirer."[145] In other words, "both poison pill varieties menace an acquirer with the prospect of severely diluting its equity investment."[146]

Distilled to essentials, the poison pill is just a fancy way for a target company to deliberately dilute a hostile stockholder by issuing stock at discounted prices.[147] Again, the corporation issues stock in exchange for inadequate consideration, but the corporate pie only gets bigger. At the same time, pie slices owned by non-hostile stockholders grow wider at the expense of the hostile stockholder, whose slice gets narrower. Regardless of whether

---

[142] A necessary corollary is that corporate fiduciaries may act in ways that benefit the stockholders but not the company without breaching fiduciary duties, even though the harm and benefit flow to different parties. And the offset need not be exact—transaction costs or other considerations may result in some disparity.

[143] *See, e.g.*, Tilden v. Cunningham, 2018 WL 5307706, at *2 (Del. Ch. Oct. 26, 2018) ("claims relating to Blucora's stock repurchases" are "also derivative").

[144] Jordan M. Barry & John William Hatfield, *Pills and Partisans: Understanding Takeover Defenses*, 160 U. PA. L. REV. 633, 642 (2012).

[145] *Id.*

[146] *Id.*

[147] That companies are at all willing to do so is, itself, evidence that non-issued stock is valueless to the company.

the poison pill is challenged when enacted or when triggered, the claim is direct because the company as a whole is unaffected by machinations over how the pie is distributed between stockholders.

Recognizing dilution as direct closes a doctrinal inconsistency between how Delaware law treats poison pills and how it treats other forms of equity dilution. Until recently, "[c]ases have divided as to whether the issuance of a 'poison pill' security can be challenged by a direct action on the grounds that it chills voting rights or restricts the alienability of the shareholder's stock,"[148] or is instead derivative except in the narrow context of an active "proxy battle."[149] Then-Vice Chancellor Strine criticized, but was ultimately bound by, special injury precedent holding that poison pills should be challenged derivatively, asking "why a board's action to interpose itself between stockholders who are ordinarily free to sell their shares, and purchasers who are ordinarily free to buy those shares—if improper—works an injury on the corporation as an entity."[150] Finally, in 2021, Chancellor McCormick held in *Williams Companies S'holder Litigation* that challenging a poison pill is a direct claim under *Tooley*, stating that "[a]ll rights plans interfere to some degree with the right to sell and the right to vote," and that the specific plan before her also restricted stockholder communications, "whether with other stockholders or management. . . . This articulation of the harm flows to stockholders and not the Company."[151]

The Chancellor is surely right. But *Williams*' holding further highlights the infirmities in the "classical" view of Delaware law on equity dilution. All poison pills are stock issuances that threaten equity dilution, and all stock dilution interferes with the right to vote. If the "classical" view were correct, challenging a poison pill is at minimum dual-natured. This tension exists only because that view is not correct. Recognizing that dilution harms only stockholders, reconciles Delaware's treatment of poison pills with stock dilution generally.

The Dual-Natured Claim: Mixed Consideration. A consequence of treating equity dilution as direct and transfers of corporate assets as derivative is that a transaction involving payment in both equity and assets may be both direct and derivative. For example, when one company overpays in acquiring another with mixed stock and cash, both the buying company and its stockholders are harmed. Cash overpayment shrinks the

---

[148] AM. L. INST., 2 PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.01 n.3, at 8 (1994).

[149] Moran v. Household Intern., Inc., 490 A.2d 1059, 1070 (Del. Ch. 1985)

[150] *In re* Gaylord Container Corp. S'holders Litig., 747 A.2d 71, 78 (Del. Ch. 1999).

[151] *In re* Williams Cos. S'holder Litig., 2021 WL 754593, at *20 (Del. Ch. Feb. 26, 2021).

whole corporate pie, while stock overpayment narrows the slices. The two forms of consideration cannot be challenged separately with two different claims because they are both inextricable components of the same deal price. It is not that the company has overpaid in stock *or* cash: it has overpaid in the aggregate. Attributing the overpayment to purely the stock or cash component is meaningless.[152]

This is not an unworkable situation. The reasoning in *Gentile* may have been a special injury holdover, but *Gentile*'s treatment of what the court thought was a dual-natured claim is nevertheless instructive. *Gentile* and its progeny allowed stockholders to bring dual-natured claims directly. The Supreme Court ultimately overruled *Gentile* because its "erosion of Tooley's simple analysis" made it "difficult[]" for "courts" to "apply[] *Gentile* in a logically consistent way,"[153] but that logical inconsistency related to when dilution claims were direct, rather than derivative. There is nothing inherently incoherent about dual-natured claims existing.

Rather, the primary complication of dual-natured claims is the "practical problem of allowing two separate claimants to pursue the same recovery."[154] But that is not difficult to resolve. Delaware courts are no strangers to competing litigants challenging the same transaction and pursuing the same recovery; courts typically consolidate such suits and appoint a lead plaintiff. Courts can similarly consolidate competing derivative and direct stockholder groups under a single lead plaintiff. Alternatively, Delaware courts can stay one action in favor of the other, which is what currently happens when a parallel representative litigation is already proceeding in another court. Further, *res judicata* bars all further claims once one claim is resolved, so dual-natured claims cannot result in double recovery nor otherwise "unnecessarily complicate[] fashioning a remedy."[155] If the concern is what form a consolidated recovery should take, Delaware courts already contemplate a wide range of possible remedies through the exercise of their discretion,[156] and lead plaintiffs would—as they already do—push for their preferred remedy. These objections also assume

[152] Delaware law indicates that direct claims require a stockholder "injury independent of an injury to the corporation"; specifically, "the inquiry should focus on whether an injury is suffered by the shareholder that is not dependent on a prior injury to the corporation." Agostino v. Hicks, No. CIV.A. 20020-NC, 2004 WL 443987, at *5-6 (Del. Ch. Mar. 11, 2004). Overpayment in a mix of stock and cash does not depend on any "prior injury to the corporation." Rather, the stockholders and the company are concurrently harmed.
[153] Brookfield Asset Mgmt., Inc. v. Rosson, 261 A.3d 1251, 1276 (Del. 2021).
[154] *Id.* at 1277.
[155] *Id.*
[156] *See supra* Section III.C.

that dual-natured claims can be brought both derivatively and directly. Courts could well impose a bright line rule that requires all such claims be brought as one or the other.[157] But ultimately, the most obvious rebuttal to concerns about recovery is that in *Gentile*'s fifteen-year lifespan, objections to its analytical coherence abound, but there has been no litigation concerning its practical impact (if any) on recovery.[158]

Convertible Notes. The *Gentile* fact pattern, on the other hand, poses a much neglected and interesting scenario. The company in *Gentile* borrowed cash from its CEO/controller and paid him in convertible notes; the CEO/controller could choose repayment or to redeem his notes as stock.[159] At the time of the transaction, the cash inflow from the loan increased the size of the corporate pie. The convertible note, however, is a curious instrument. If the CEO/controller then demanded repayment in cash, the repayment would have offset the inflow of borrowed cash and reduced the size of the whole pie; an overpayment claim would have been derivative. But if the CEO/controller chose to convert the notes to stock, other stockholders would have paid with their economic and voting rights, not the company. That overpayment would be direct because stockholders' slices would have narrowed.

Ultimately, the CEO/controller chose to redeem his notes for stock. In fact, the company in *Gentile* did not even have enough authorized stock to satisfy the conversion; it had to seek stockholder approval to amend the charter to authorize more shares.[160] And before the controller exercised the conversion, the company and the controller negotiated to decrease the

---

[157] There are other ways to treat dual-natured claims. Before *Gentile* was overruled, Vice Chancellor Laster suggested, in the context of a claim for breach of a limited partnership agreement, that:

> Delaware law can and should treat a dual-natured claim as derivative for purposes of Rule 23.1 and the doctrine of demand, but as direct for purposes of determining whether sell-side investors can continue to pursue the claim after a merger. Treating a dual-natured claim as derivative for purposes of claim initiation achieves the important goals of screening out weak claims and providing an efficient and centralized mechanism for conducting the litigation. Treating a dual-natured claim as direct for purposes of claim continuation preserves the ability of investors to pursue legitimate claims, promotes accountability, and provides a superior mechanism for doing so than secondary litigation challenging the transaction that eliminated the plaintiff's standing to sue derivatively.

In re El Paso Pipeline Partners, L.P. Deriv. Litig., 132 A.3d 67, 75 (Del. Ch. 2015), *rev'd sub nom.*, *In re* El Paso Pipeline GP Co. v. Brinckerhoff, 152 A.3d 1248 (Del. 2016).

[158] At least, as far as the authors are aware.

[159] Gentile v. Rossette, 906 A.2d 91, 94 (Del. 2006).

[160] *Id.* at 95.

conversion ratio, from $0.5 of debt/share to $0.05 of debt/share, thereby increasing the amount of stock the controller would receive by a factor of 10. But none of this mattered to the company; the company kept the borrowed cash and the pie stayed the same size as it was before the redemption. Rather, the issuance transferred voting and economic rights from the minority stockholders to the controller. And it was the stockholders that company fiduciaries had to convince to approve the charter amendment increasing the number of authorized shares. *Gentile*'s conclusion that stockholders had direct standing was therefore correct.

But what if the CEO/controller chose cash, or plaintiffs chose to challenge the company's decision to issue convertible notes in the first place? Cash repayment is clearly derivative. But a claim alleging that the company overpaid in convertible notes is dual-natured. Because no one can tell the future, no one could have known when the convertible notes were issued whether the CEO/controller would later decide on cash repayment or stock redemption. And even if the litigation takes longer to resolve than for the CEO/controller to make that decision, standing is still a threshold issue that must be decided at the outset of the case.

In short, challenging a convertible note could be dual-natured, direct, ***or*** derivative depending on when litigation is initiated. An action brought at the outset alleging that the company overpaid in convertible notes is dual-natured. One brought after the CEO/controller has chosen to redeem the notes for stock is direct. And a claim challenging the notes' repayment with cash is derivative.

C. Tooley As Applied To Other Common Claims

Although this Article has focused on dilution claims, and by extension equity transactions, the corporate pie can be employed in any direct/derivative analysis. This section applies *Tooley* to a variety of paradigmatic causes of action by way of the corporate pie shorthand. Setting aside dilution, the outcomes are, unsurprisingly, consistent with current caselaw.

Sell-Side Mergers and Break-Up Transactions. Challenges by the seller's stockholders to mergers and other transactions that break up or change control of the company have historically been treated as direct.[161] And the corporate pie concurs, regardless of what consideration the target stockholders receive, because during a merger or break-up transaction, the

[161] *See, e.g.*, *Brookfield*, 261 A.3d at 1276 ("*Revlon*[] provide[s] a basis for a direct claim for stockholders to address fiduciary duty violations in a change of control context.").

buyer (or surviving company) is paying consideration for the seller's slices of the pie rather than for the seller's assets.

Take for example, the transaction in *Firefighters' Pension Sys. of City of Kansas City, Missouri Tr. v. Presidio, Inc.*,[162] where a merger target's stockholders alleged that they received insufficient cash in exchange for their shares.[163] The court held that stockholders were harmed "in the form of a lower transaction price":

> [Plaintiffs] suffered injury in the form of a lower transaction price, and any remedy logically would go to the stockholders as a class. In substance, the plaintiff is challenging the Merger and the process that led to a transaction that converted each of the shares into a right to receive $16.60, not events that took place before the merger and affected the Company as an entity. These considerations warrant characterizing the claim as direct rather than derivative.[164]

The pie produces the same result. Stockholders traded their slices—the economic and voting rights represented by their shares of stock—for $16.60 in cash. The corporate pie was unaffected. But the stockholders were harmed because they received too little for their individual slices.

This is true even when the selling stockholders receive stock in a new company, rather than cash. For example, in the CBS-Viacom merger,[165] "CBS was the putative buyer and surviving entity, providing Viacom stockholders .59625 shares of newly issued ViacomCBS stock (a name adopted by CBS following the Merger) for each Viacom share."[166] Stockholders of both corporations filed suit challenging the merger as a self-dealing transaction orchestrated by a common controller. The Viacom stockholders brought their claim as a class action.[167] After all, they exchanged their slices of the Viacom pie for slices in the ViacomCBS pie. If the ViacomCBS stock was not worth enough, Viacom stockholders suffer harm from receiving a slice worth less than the one they gave up, and any recovery would accrue to them as well.

Buy-Side Mergers and Break-Up Transactions. The answer is

---

[162] Firefighters' Pension Sys. Of City of Kansas City, Missouri Tr. v. Presidio, Inc., 251 A.3d 21 (Del. Ch. 2021).
[163] *Id.* at 273.
[164] *Id.* at 274.
[165] *In re* CBS Corp. S'holder Class Action & Derivative Litig., 2021 WL 268779, at *26 (Del. Ch. Jan. 27, 2021), *as corrected* (Feb. 4, 2021); *In re* Viacom Inc. S'holders Litig., 2020 WL 7711128 (Del. Ch. Dec. 29, 2020), *as corrected* (Dec. 30, 2020).
[166] *In re CBS*, 2021 WL 268779, at *26.
[167] *In re Viacom*, 2020 WL 7711128, at *10.

murkier when the buyer's stockholders sue for overpayment. As noted in Section IV.B., *supra*, when a company overpays in cash or other assets, that claim is derivative.[168] But as we argued extensively throughout this Article, the claim should be direct when the overpayment is in stock.

In 2016, Oracle Corporation acquired Netsuite, Inc. for $109 in cash per Netsuite share. Oracle stockholders challenged that acquisition as an overpayment; both the plaintiffs and the court agreed that that claim was derivative.[169] And the corporate pie framework agrees. Oracle paid for NetSuite shares with cash; cash is an asset of the corporation, the outflow of which decreases the corporate pie. A claim for overpayment—that the outflow of cash was greater than the inflow from Oracle's acquisition of NetSuite shares—causes the pie to allegedly shrink due to wrongdoing. The claim is derivative under the pie framework.

Now revisit the CBS-Viacom merger. The CBS stockholders brought what looked like a classic overpayment claim where CBS overpaid in stock for its purchase of Viacom shares, which Delaware courts have traditionally viewed as derivative:[170]

> According to Defendants, the gravamen of Plaintiffs' claim is that CBS fiduciaries "caused CBS to massively overpay for Viacom." If that, in fact, is the claim, then the claim is derivative. Indeed, "a claim that an entity has issued equity in exchange for inadequate consideration—a so-called dilution claim—is a quintessential example of a derivative claim." And that is precisely how this Merger appears to have been structured.[171]

The plaintiffs disputed this characterization, arguing that, in actuality, Viacom acquired CBS and not the other way around. They pointed out that ViacomCBS "now operates under the control of a majority NAI/Viacom board, with a majority of Viacom's former executives at the helm, in Viacom's former headquarters, and its stock now trades on Viacom's (not CBS's) former exchange (NASDAQ) under the ticker symbols 'VIACA' and 'VIAC.'"[172] The court remarked that plaintiffs' characterization "carr[ied] some creative force" and noted that "equity regards substance rather than

---

[168] *See, e.g.*, *In re* Oracle Corp. Derivative Litig., 2018 WL 1381331, at *1 (Del. Ch. Mar. 19, 2018).
[169] *Id.*
[170] *See supra* Part II.
[171] *In re CBS*, 2021 WL 268779, at *26 (citing *In re J.P. Morgan*, 906 A.2d at 818–19; *In re El Paso*, 152 A.3d at 1265 (Strine, C.J., concurring)). See *supra* Part II (discussing both *JP Morgan* and Chief Justice Strine's *El Paso* concurrence).
[172] *In re CBS*, 2021 WL 268779, at *27 (characterizing Plaintiffs' argument).

form." [173] But the court ultimately did not reach the issue because, "even if Plaintiffs' claims [we]re derivative, they ha[d] well pled them as such."[174]

The corporate pie, however, conveniently sidesteps the issue of who acquired whom, whether substance or form governs, and would have saved the Court from having to conduct a full demand futility analysis. CBS "provid[ed] Viacom stockholders .59625 shares of newly issued ViacomCBS stock . . . for each Viacom share."[175] The CBS pie did not shrink because the issued stock had no entity-level value. In fact, CBS massively expanded because it now owned all of Viacom. Rather, CBS stockholders paid for all of that Viacom stock because their proportionate slices of the combined entity had narrowed. The claim is direct.

Caremark. Recent years have seen a considerable uptick in litigation alleging that corporate fiduciaries breached their duty to monitor, either by (i) "utterly fail[ing] to implement any reporting or information system or controls"; or (ii) "having implemented such a system or controls, consciously failed to monitor or oversee its operations."[176] It is well settled that these claims are derivative and the corporate pie agrees. Regardless of whether directors fail to oversee food safety—before a listeria outbreak kills three people and forces an ice cream company to shut down all of its factories[177]—or monitor pipeline integrity—before a rupture dumping 3,400 barrels of oil into the environment leads to reputational harm, company fines, and lost revenue[178]—the harm stockholders say are caused by alleged breaches of duty in these cases are all entity-level damages to the whole pie.

Asset Sales and Transfers. Asset sales generally give rise only to derivative claims under Delaware law.[179] As explained in Section IV.A., a claim that assets were sold for too little harms the company first—it shrinks the corporate pie as a whole, because the pie has parted with valuable consideration in exchange for consideration worth less.

The seminal case of *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* is no exception.[180] That case is at times described as enjoining a "'bust-

---

[173] *Id.*
[174] *Id.*
[175] *Id. at* *27.
[176] City of Detroit Police & Fire Ret. Sys. *ex rel.* NiSource, Inc. v. Hamrock, 2022 WL 2387653, at *12 (Del. Ch. June 30, 2022).
[177] *See* Marchand v. Barnhill, 212 A.3d 805 (Del. 2019).
[178] *See* Inter-Mktg. Grp. USA, Inc. v. Armstrong, 2020 WL 756965 (Del. Ch. Jan. 31, 2020).
[179] Note that sales of the company's own equity are not included in the "asset sales" category. As described at length *supra* Part III, the company's own equity is not truly an asset of the corporation.
[180] 506 A.2d 173, 175 (Del. 1986).

up' sale of assets,"[181] even though the claims brought were direct. Understanding the discrepancy requires a deeper look at the structure of the transaction at issue. In *Revlon*, the challenged transaction was a leveraged buyout. Forstmann contemplated buying Revlon for $57.25 in cash per Revlon share, a purchase which would be funded in part by Revlon selling off three of its divisions to third parties.[182] Although the deal had two aspects—a sale of three divisions and a purchase of Revlon stockholders' Revlon shares for cash—plaintiffs challenged only the latter. In other words, although the *Revlon* transaction involved a "bust-up" sale of assets, the asset sale itself was not challenged. The litigation over the $57.25/share offer is clearly direct for the same reasons described *supra* in Sell-Side Mergers and Breakup Transactions.

Compensation. Director and officer compensation is ultimately a subspecies of either an asset sale, an equity sale, or a mix of both. Under existing law, compensation claims are exclusively derivative because Delaware law treats equity dilution the same as cash waste. But of course, while challenges to purely cash compensation allege that the company overpaid, thereby reducing the size of the whole corporate pie, challenges to equity compensation do not involve any transfer of a corporate asset for the reasons described above.[183] Today, compensation packages often involve both cash payment from the company and some form of equity that redistributes economic and voting rights from existing stockholders to the recipient. It is not possible to adjudicate the cash and equity components separately, as whether a compensation package is fair or waste is based on its total value rather than any single component. Consequently, as discussed in Section IV.B., *supra*, any claims arising therefrom are dual-natured.

V. CONCLUSION: STARE DECISIS AND EQUITY DILUTION

We hoped to demonstrate in this Article that equity dilution does not harm the company, injures only stockholders, and is therefore properly treated as a direct claim under *Tooley*. If one accepts the premise that treasury

[181] *See, e.g.*, Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1150 (Del. 1989) ("[I]n *Revlon,* when the board responded to Pantry Pride's offer by contemplating a 'bust-up' sale of assets in a leveraged acquisition, we imposed upon the board a duty to maximize immediate shareholder value and an obligation to auction the company fairly.").
[182] *Revlon*, 501 A.2d at 1245 ("To help finance Forstmann's transaction, Revlon agreed to sell its Norcliff Thayer and Reheis divisions to American Home Products for $335 million, and to sell the Beauty Products Division to Adler & Shaykin in an independent transaction for approximately $900 million."), *aff'd*, 505 A.2d 454 (Del. 1985).
[183] *See supra* Sections III.B., IV.A.

and otherwise unissued stock is valueless and does not contribute to or otherwise affect an entity's enterprise value, it is difficult to see how corporate fiduciaries can inflict entity-level damage by selling that stock at too low a price. For those who are unconvinced, hopefully this Article at least introduces a useful heuristic that makes applying *Tooley* easier, particularly given the complex transactions that are litigated daily in Delaware courts.

Otherwise, the fact that dilution claims are so "classically" derivative is a substantial obstacle to any consistent application of the *Tooley* framework going forward. This axiom has by this point been a part of Delaware's legal firmament since the 1953 *Elster* decision, and has been intoned as mantra year-after-year, case-after-case, largely unquestioned for seventy years. Even *Gentile* started by acknowledging the allegedly derivative nature of dilution claims, and recognized dilution only as dual-natured. And even then, only if the allegations concerned controller expropriation. Regardless of whether *Tooley* or special injury served as the reigning doctrinal framework, Delaware courts have always classified dilution claims as derivative.

The question now is not whether the derivative dilution claim is consistent with the law. It is not. Rather, we must ask whether derivative dilution claims are wrong enough to justify setting aside *stare decisis*. In *Brookfield*, the court overruled *Gentile* only after "giv[ing] all due consideration to the weight of precedent":

> This Court decided *Gentile* fifteen years ago. This is old enough, we think, that we can properly say that the practical and analytical difficulties courts have encountered in applying it reflect fundamental unworkability and not growing pains, but not so old as to carry the weight of "antiquity." Moreover, that gap in time has given us the perspective to see that *Gentile* is more of a departure from the then-recent *Tooley* than the continuation we perceived it to be at the time. Any reliance is further muted by *El Paso*, from which parties could rightly anticipate that *Gentile*'s continued viability was in doubt. Finally, in overturning it today we speak unanimously, with the concomitant aid to certainty that provides.[184]

We venture that the derivative dilution claim is just as analytically infirm as *Gentile*. *Brookfield* took issue with the fact that *Gentile* provided an exception to *Tooley* in the context of equity dilution by a controller, an exception based on the special injury framework *Tooley* supplanted. The derivative dilution claim is not only also a special injury relic, but an even

---

[184] Brookfield Asset Mgmt., Inc. v. Rosson, 261 A.3d 1251, 1280 (Del. 2021).

broader exception to *Tooley* that affects ***all*** claims involving equity issuances. The idea that the company suffers "harm" on account of an overpayment in stock that is worth something only to stockholders is—without more—wrong, in our view. The derivative dilution claim cannot be squared with *Tooley* and *Tooley* will never have "exclusive" application so long as Delaware courts continue to shelter such a glaring exception.

As for reliance, it is hard to see how plaintiffs or defendants suffer any "reliance" injury should Delaware courts recognize dilution claims as direct. Stockholders would probably prefer to style their claims as class actions so as to avoid the need to plead demand futility. And it is unlikely that the would-be corporate defendants who are structuring significant transactions are doing so in reliance on an arcane legal rule—likely of interest only to litigators and academics—that any resulting dilution claim must satisfy the requirements of Rule 23.1.[185] Furthermore, the Supreme Court signaled *Gentile*'s demise in *El Paso*, five years before *Brookfield*. Reducing reliance on cases that are inconsistent with governing law is something entirely within courts' control.

The best defense, then, for preserving the derivative dilution claim is "the weight of 'antiquity.'"[186] That too is a thin justification. On its face, the concept is seven decades old. But as *Brookfield* confirmed with respect to *Gentile*, the operative age is not how long courts have treated dilution claims as derivative, but how long they have done so under the ***current*** legal framework. *Gentile* may have been in place only "fifteen years,"[187] but like the derivative dilution claim, their shared special-injury antecedents date back to 1953. Of course, pre-*Tooley* cases treated dilution as derivative; the law was after all different back then. *Tooley* was only decided in 2004. And the cases that reinjected special injury-based analysis of equity dilution into *Tooley*'s analytical framework are now at most a spritely 19 years of age. That hardly counts as "antiquity." Special injury was already 50 when *Tooley* attempted unsuccessfully to sweep it away.

It may well take time before litigators and Delaware courts revisit the "classical" view of dilution. But as *Tooley* approaches its second decade and its "exclusive" application remains elusive, we think a reassessment of how *Tooley* is applied to stock overpayment is now due.

---

[185] Anecdotally, in an unofficial and scientifically unsound poll of the authors' transactional attorney colleagues working on mergers and acquisitions at national law firms, all answered no. Most have had no need to consider Rule 23.1 since graduating law school.
[186] *Brookfield*, 261 A.3d at 1280.
[187] *Id.*