

Chancery Addresses Disclosure Duties to Minority When Majority Acts by Written Consent

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In the most recent of three written opinions from the Court of Chancery in *Dubroff v. Wren Holdings LLC*, the court addressed an array of issues useful to business litigators, including: (i) whether and when a minority shareholder's claim for breach of fiduciary duty against a control group based on equity dilution is a direct or derivative claim; (ii) whether a disclosure claim regarding a recapitalization plan can proceed despite alleged "inquiry notice" or alleged ratification via a stockholders agreement; (iii) whether the statute of limitations for individual claims by members of a class action is tolled while the class action is pending; and (iv) the procedural nuances between motions to intervene and consolidate.

In 2002, a group of Nine Systems Corp. shareholders representing a majority of the shares (the control group) approved by written consent a reorganization plan that involved a reverse stock split, issuance of new classes of stock, and an amendment to the certificate of incorporation (the recapitalization). The recapitalization resulted in an increase of the control group's equity ownership of NSC from 56 to 90 percent, and a simultaneous dilution of the minority shareholders' equity.

This case involves two sets of plaintiffs, both of whom were minority shareholders in NSC. The court referred to the two groups as the *Dubroff* plaintiffs and the *Fuchs* plaintiffs. In the two prior decisions in this case, the court dismissed many of the *Dubroff* plaintiffs' claims and also denied class certification. The *Fuchs* plaintiffs, a group of 43 shareholders each pursuing direct, individual claims against NSC, filed a separate suit and sought to both intervene in, and consolidate their case with, the *Dubroff* plaintiffs' pending suit.

The defendants filed motions to dismiss the *Fuchs* plaintiffs' complaint, arguing, *inter alia*, that the *Fuchs* plaintiffs' claims were barred because NSC disclosed information about the recapitalization to the minority shareholders in the stockholders agreement, which many of the *Fuchs* plaintiffs signed in 2002. They also moved to dismiss on jurisdictional and other grounds.

While NSC made certain generalized disclosures about the recapitalization in the 2002 stockholders agreement, ultimately, the disclosures were insufficient to prevail on a motion to dismiss. The court found that the disclosures were deceptive and failed to reveal certain material terms of the recapitalization, specifically that the control group was the primary beneficiary of the recapitalization.

EQUITY DILUTION

Customarily, equity dilution claims are viewed as derivative, rather than direct, claims under Delaware law. But several years ago, in *Gentile v. Rossette*, the Delaware Supreme Court held that certain equity dilution claims may be pled both derivatively and directly. In *Dubroff*, the defendants argued that because some of the *Fuchs* plaintiffs received preferred stock (the same benefit conferred on the control group), the defendants had not received an "exclusive benefit" as

required by the Delaware Supreme Court in *Gentile*. The Court of Chancery in *Gentile*, however, found that the minority shareholders could assert a direct claim for equity dilution because their holdings were diluted, and the control group's holdings were not. There did not have to be a direct correlation or "exact match" between the control group's gain and the minority's loss. Nor did it matter that some of the plaintiffs received the same class of stock as the control group members.

The court criticized both the syllogism used by the defendants and Delaware decisions that suggested if anyone other than the controller benefits from the transaction, then the minority may not assert a direct dilution claim. Rather, the court explained that:

"A corporation's minority shareholders should not be denied a direct equity dilution claim where a controller expropriates, from them, a large percentage of the corporation's equity, keeps most of that expropriated equity for itself, and gives a small amount to other people."

The court devoted a significant amount of time discussing the factual allegations that led the court to consider the individual members of the control group as a single controlling unit. This type of analysis is highly fact sensitive and plaintiffs in this type of case should be overly inclusive in pleading that the individual members of a control group worked together to accomplish a common goal.

FIDUCIARY DUTIES

Next, the court affirmed Delaware decisions holding that members of a control group with controlling shareholder status owe fiduciary duties to minority shareholders. The court discussed the pleading requirements to overcome a motion to dismiss a claim for aiding and abetting a breach of fiduciary duty. While the court was not overwhelmed by plaintiffs' aiding and abetting allegations, they were sufficient to withstand a motion to dismiss.

In connection with the recapitalization, the control group, as holders of the majority of the stock of NSC, approved the recapitalization by written consent. DGCL Section 228(e) requires that after a majority approves a transaction by written consent, "prompt notice of the taking of the corporate action without a meeting by less than unanimous consent shall be given to those stockholders ... who have not consented in writing." Although several of the Fuchs plaintiffs were aware of the recapitalization because they signed the stockholders agreement that contained general disclosures, and all the plaintiffs received the notice sent by NSC pursuant to Section 228(e), the court found that the disclosures were insufficient.

Neither the notice nor the disclosures in the stockholders agreement identified either: (i) the beneficiaries of the recapitalization, or (ii) what benefits they received. It was not until four years after the recapitalization, when NSC was purchased for \$175 million, that the Fuchs plaintiffs learned that the minority shareholders held less than 6 percent of NSC's outstanding equity securities.

Based on the defendants' failure to provide material information about the recapitalization in the required disclosures, the court agreed that these material omissions prevented the Fuchs plaintiffs from bringing an earlier action to rescind the recapitalization.

The court acknowledged that the precise contours of the disclosures required under DGCL Section 228(e) have not yet been defined under Delaware law, but notwithstanding that lack of guidance, the Fuchs plaintiffs had pleaded sufficient facts for the court to infer that the board deliberately omitted material information for the purpose of misleading shareholders about the control group's material financial interest in, and benefit conferred by, the recapitalization.

Likewise, there was sufficiency in the pleadings for a fiduciary duty claim to proceed on the disclosure issue since the directors communicated directly with shareholders about corporate matters, but were less than completely forthcoming.

STATUTES OF LIMITATIONS

It remains axiomatic that the Chancery, as a court of equity, is not strictly bound by statutes of limitations; although absent a tolling of the limitation period, the court gives great weight to statutory time limits on certain claims. Breach of fiduciary duty claims are typically subject to a three-year statute of limitations. In this case, however, neither the stockholders agreement nor the subsequent notice of written consent put the minority shareholders on "inquiry notice" of the alleged self-dealing nature of the recapitalization. The stockholders agreement was not intended as a disclosure document; and the notice did not sufficiently disclose the material facts about the transaction.

As for tolling, the U.S. Supreme Court has interpreted Rule 23 to mean that class members' individual claims are tolled while a putative class action is pending. Otherwise, the intent of class action litigation - to simplify litigation involving a large number of class members with similar claims - would be defeated, especially if each of them was forced to intervene to preserve their claims. The Court of Chancery reasoned that a "class action tolling rule makes sense" and announced that rule as Delaware law. The court ruled also that the Fuchs plaintiffs' claims were tolled while the Dubroff plaintiffs' putative class action claims were pending; and that their complaint should not be dismissed based on laches because the Fuchs plaintiffs quickly sought to vindicate their rights after the Dubroff plaintiffs' motion for class certification was denied.

After ruling on the motions to dismiss, the court turned to the Fuchs plaintiffs' motion to intervene in the Dubroff plaintiffs' case. The court provided a helpful analysis of Rules 24(a) and 24(b) regarding mandatory and permissive intervention and noted that because the outcome of the Dubroff plaintiffs' claims would not affect the Fuchs plaintiffs' claims, there was no right of intervention. While the court in its discretion could have permitted the Fuchs plaintiffs to intervene, the appropriate approach in this case was consolidation under Rule 42. The court explained that consolidation is more suitable where two groups of plaintiffs are proceeding under two different complaints (since many of the Dubroff plaintiffs' claims were dismissed).