The Distinction Between Direct and Derivative Shareholder Claims

*James An**

Abstract

One of the primary methods for shareholders to seek redress for corporate misconduct is the shareholder suit, in which shareholders may assert either "direct" or "derivative" claims. Under current legal doctrine, direct claims nominally seek to assert a right of the individual shareholder, while derivative claims seek to assert a right that formally belongs to the corporation and is asserted by the shareholder on the corporation's behalf. Due to legitimate risks of shareholder and judicial overreach, courts have imposed numerous procedural hurdles upon derivative suits, making them much harder to bring than direct suits.

Although the distinction between direct and derivative claims is often outcome-determinative, the specific rules governing that distinction have long been flawed, with courts and commentators calling those rules "subjective," "opaque," and "muddled." Moreover, the predominant Tooley *test prevents courts from addressing numerous management misdeeds, thus harming shareholders and impairing justice. This Article explains how the* Tooley *test is fundamentally intractable and leads to gaming by transactional planners. Returning then to the underlying principles of corporate law, this Article proposes another test based on (1) the availability of alternative governance solutions, and (2) relative judicial competency.*

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* Teaching Fellow, LL.M. Program in Corporate Governance, and Lecturer in Law, Stanford Law School. I especially thank Joel Fleming, Mark Lebovitch, and Eric Talley for prompting a substantial revision of this Article. I am also grateful to Albert Choi, Itai Fiegenbaum, Joel Friedlander, Frank Gevurtz, J.B. Heaton, Michael Klausner, Holger Spamann, and the attendees of the 2023 Corporate and Securities Litigation Workshop for their excellent thoughts and comments.

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Introduction

The shareholder suit is the primary means by which shareholders can seek retrospective redress for wrongs committed by the managers to whom shareholders have entrusted their capital.[1] One of the first questions that courts ask of these shareholder suits—often before otherwise basic matters such as standing or whether a complaint states a claim upon which relief can be granted—is whether the pleaded claims are "direct" or "derivative."[2]

The distinction between direct and derivative claims is often outcome-determinative and has profound impacts upon how a shareholder suit is conducted.[3] Among other things, derivative claims are

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1 *See* Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984) (characterizing shareholder suits as "potent tools to redress the conduct of a torpid or unfaithful management").

2 *See, e.g.*, Grimes v. Donald, 673 A.2d 1207, 1212–13 (Del. 1996), *overruled in part by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000) (evaluating whether a claim is direct or derivative before determining the applicable pleading standard).

3 Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1036 (Del. 2004); E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992–2004? A Retrospective on Some Key Developments*, 153 U. Pa. L. Rev. 1399, 1468 (2005) (calling the distinction "of critical importance"); Richard Montgomery Donaldson, *Mapping*

disadvantaged because they (1) must, as a practical matter, plead demand futility, an onerous standard that requires a plaintiff to demonstrate that more than half of the directors of a corporation are conflicted;[4] (2) may be taken over by a special litigation committee appointed by the corporation's board;[5] and (3) can only be prosecuted by current shareholders, a rule that effectively extinguishes the claims of selling shareholders upon a merger.[6] Direct claims, on the other hand, are subject to none of these constraints and are generally much easier to file and maintain.[7] In other words, a plaintiff is much less likely to recover a claim that can only be pleaded derivatively. Unfortunately, the current standard for distinguishing between direct and derivative claims in corporate law is woefully flawed, with courts and commentators frequently complaining that the doctrine for distinguishing between direct and derivative claims is abstruse, inconsistent, or otherwise difficult to apply.[8]

The Delaware Supreme Court case *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*[9] created the predominant[10] *Tooley* test, which asks the following: "(1) who suffered the alleged harm (the corporation or the suing

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Delaware's Elusive Divide: Clarification and Further Movement Toward a Merits-Based Analysis for Distinguishing Derivative and Direct Claims in Agostino v. Hicks *and* Tooley v. Donaldson, Lufkin & Jenrette, Inc., 30 Del. J. Corp. L. 389, 390 (2005).

4 United Food & Com. Workers Union v. Zuckerberg, 262 A.3d 1034, 1047, 1058–59 (Del. 2021). Plaintiffs may also, in theory, plead wrongful refusal of a demand, though that is even more difficult. *See, e.g.*, Ironworkers Dist. Council of Phila. v. Andreotti, No. 9714-VCG, 2015 WL 2270673, at *25 (Del. Ch. May 8, 2015), *aff'd*, 132 A.3d 748 (Del. 2016).

5 Zapata Corp. v. Maldonado, 430 A.2d 779, 786 (Del. 1981); London v. Tyrrell, No. 3321-CC, 2010 WL 877528, at *11 (Del. Ch. Mar. 11, 2010).

6 Lewis v. Anderson, 477 A.2d 1040, 1049, 1051 (Del. 1984); El Paso Pipeline GP Co. v. Brinckerhoff, 152 A.3d 1248, 1265 (Del. 2016).

7 *See, e.g.*, MCG Cap. Corp. v. Maginn, No. 4521-CC, 2010 WL 1782271, at *4 (Del. Ch. May 5, 2010) (observing that the standards "of Rule 8(a) [which] apply to direct claims" are "relatively simpler" than the "standards of Rule 23.1 [which] apply only to derivative claims").

8 *See* Dinuro Invs., LLC v. Camacho, 141 So. 3d 731, 739 (Fla. Dist. Ct. App. 2014) (calling the direct-derivative distinction "incredibly opaque"); Lopez Languirand v. Lopez, 261 So. 3d 1054, 1059 (La. Ct. App. 2018) (calling the distinction "difficult" and "challenging"); *Tooley*, 845 A.2d at 1034 (describing previous jurisprudence as "confusing"); *El Paso*, 152 A.3d at 1254 (calling the issue "complex"); JP Haskins, Note, *Whose Harm Is It Anyway?—The Feasibility of Direct Claims by Minority Shareholders Following Cash-Out Mergers in Texas Corporations*, 68 Baylor L. Rev. 564, 568 (2016) (calling the distinction "easily muddled"); George S. Geis, *Shareholder Derivative Litigation and the Preclusion Problem*, 100 Va. L. Rev. 261, 271–72 (2014) (calling the distinction "fuzzy" and stating that "it can be difficult to determine whether a . . . claim is direct or derivative"); Veasey & Di Guglielmo, *supra* note 3, at 1468 (calling the distinction "slippery"); Donaldson, *supra* note 3, at 389–90 (calling the distinction "highly subjective," "unpredictable," and "elusive").

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

10 Because of Delaware's dominance in American corporate law, the *Tooley* test is correspondingly dominant as the prevailing test for distinguishing between direct and derivative claims. *See* Murphy v. Inman, 983 N.W.2d 354, 370 (Mich. 2022); Parametric Sound Corp. v. Eighth Jud. Dist. Ct., 401 P.3d 1100, 1102 (Nev. 2017); Corwin *ex rel.* Beatrice Corwin Living Irrevocable Tr. v.

[shareholders] individually); and (2) "who would receive the benefit of the recovery or other remedy (the corporation or the shareholders individually)?"[11] If the answer to the foregoing questions are that the corporation suffered the alleged harm and would receive the benefit of a recovery, then the claim is considered derivative; and if individual shareholders suffered the alleged harm and would receive the benefit of a recovery, then the claim is considered direct.[12]

But *Tooley* is deeply flawed. The first prong of *Tooley* is subject to manipulation, as it depends critically on how a transaction is framed and treats economically identical injuries differently depending on that framing. *Tooley*'s second prong, in turn, can be answered in multiple ways for the same transaction. Moreover, courts applying *Tooley* often reach internally inconsistent results, such as concluding that a claim must be brought derivatively even when the corporation suffered no injury. A notable recent example of this is *Brookfield Asset Management, Inc. v. Rosson*,[13] in which the Delaware Supreme Court held that claims arising out of transactions in which a corporation issued excessive stock for inadequate consideration are derivative, even though such transactions result in more corporate assets and shareholder equity.[14]

These flaws result in legal doctrine that is difficult to administer and incentivizes transaction planners to transmogrify deals to avoid direct claims. The ultimate results are increased transaction costs, lowered efficiency, and thwarted justice. For these reasons and more, *Tooley* can and should be discarded.

Instead, the proper test for whether a claim is direct or derivative should analytically ground itself in an examination of (1) the availability of redress via other governance rights, and (2) courts' relative competencies. Accordingly, claims asserting harm to shareholder governance rights, such as the right to vote, should be considered direct. Claims of shareholder harm that are unresolvable via exercise of those rights, such as claims alleging controlling shareholder self-dealing, should also be considered direct. Such claims indicate that shareholders' ability to protect themselves outside of the courts has been undermined. In addition, these claims often involve procedural questions, such as whether a negotiation took place at arm's length, in which courts have greater relative competence.

But other claims, such as claims against the corporation's contractual counterparties or claims of operational mismanagement in widely

Brit. Am. Tobacco PLC, 821 S.E.2d 729, 735 (N.C. 2018); Keller v. Est. of McRedmond, 495 S.W.3d 852, 875–77 (Tenn. 2016); Yudell v. Gilbert, 949 N.Y.S.2d 380, 381 (App. Div. 2012).

11 *Tooley*, 845 A.2d at 1033.

12 *See id.* at 1038–39.

13 261 A.3d 1251 (Del. 2021).

14 *Id.* at 1255, 1265–66.

held corporations, are appropriately considered derivative as shareholders may seek redress via other governance rights, including their right to elect a new board of directors. Moreover, judicial resolution of such matters often requires the parties to engage in costly litigation and courts to make difficult hindsight evaluations of business judgment. Categorizing such claims as harder-to-make derivative claims reduces these burdens and helps mitigate the collective action problem that would arise if individual shareholders could threaten to disrupt the functioning of the corporation via unbridled litigation.

Part I of this Article gives an overview of policy and history behind the distinction between direct and derivative claims and summarizes the modern test for whether a claim is characterized as direct or derivative. Part II critiques the analytical reasoning and economic understanding behind the current law. Then, given *Tooley*'s reliance on a misunderstanding of the history of the direct-derivative distinction, Part III presents a fresh account of that history[15] to explain why that reliance was misplaced. Part IV discusses and explores a revised two-factor test for determining whether a claim is direct or derivative. The Conclusion follows.

I. The Current Distinction Between Direct and Derivative Claims

This Part begins by summarizing principles underlying the direct-derivative distinction, which has long been a part of corporate law. It then turns to the modern *Tooley* test for distinguishing direct and derivative claims and discusses some of *Tooley*'s most notable progeny. In order to focus the discussion in this Part, a fuller history of the caselaw is reserved for Part III.

A. *The Foundations of the Direct-Derivative Distinction*

A few policy axioms underlay the development of corporate law in general and of the direct-derivative distinction in particular. First, it

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15 For examples of previous accounts, see Christine J. Chen & Y. Carson Zhou, Tooley *Brooks No Exceptions—Equity Dilution Is Direct*, 26 U. Pa. J. Bus. L. 1, 14–22 (2023); Ann M. Scarlett, *Shareholder Derivative Litigation's Historical and Normative Foundations*, 61 Buff. L. Rev. 837, 860–86 (2013) (summarizing English and American developments through the mid-20th century); Zachary D. Olson, Note, *Direct or Derivative: Does It Matter After* Gentile v. Rossette*?*, 33 J. Corp. L. 595, 599–613 (2008) (summarizing Delaware caselaw through *Gentile v. Rossette*, 906 A.2d 91, 99 (Del. 2006)); Kurt M. Heyman & Patricia L. Enerio, *The Disappearing Distinction Between Derivative and Direct Actions*, 4 Del. L. Rev. 155, 156–66 (2001) (summarizing Delaware caselaw through *Parnes v. Bally Entertainment Corp.*, 722 A.2d 1243, 1245 (Del. 1999)). *See generally* Bert S. Prunty Jr., *The Shareholders' Derivative Suit: Notes on Its Derivation*, 32 N.Y.U. L. Rev. 980 (1957). *See also Brookfield*, 261 A.3d at 1267–76; *Tooley*, 845 A.2d at 1036–39; Agostino v. Hicks, 845 A.2d 1110, 1115–21 (Del. Ch. 2004).

is desirable for people with capital, i.e., investors, to be able to entrust that capital to people with good ideas instead of only being able to fund their own ideas.[16] Second, it is desirable that people with those good ideas, i.e., management, can access capital to execute their good ideas.[17] Third, it follows that it is desirable for management to use shareholders' capital prudently and for shareholders' benefit, as no sensible investor would give capital to management who intends to and is allowed to take the money and run.[18]

Corporate law has developed some features to balance the rights of management and of investors. Features of corporate law that might be said to empower management, such as the board, include: (a) the courts' general deference to board decisions under the business judgment rule,[19] (b) the board's ability to choose the time and place of shareholder meetings,[20] and (c) the indirect selection and replacement of officers.[21] On the flip side, features that might be said to empower shareholders include: (a) voting rights,[22] (b) inspection rights of the corporation's books and records,[23] and (c) the imposition of fiduciary duties upon management.[24] Some of these investor rights, such as voting rights, are in large part mechanisms for the enforcement of other rights, such as the right to dutiful conduct by managers. The right to file a shareholder suit is notable in that it is exclusively an enforcement mechanism for redressing violations of other shareholder rights.

In the earliest shareholder suits, shareholders would assert a violation of some "individual" right of the shareholder against the corporation.[25] These violations often involved the mishandling of stock. For instance, plaintiffs would allege that a corporation had failed to recognize a valid stock transfer[26] or that a corporation had issued stock for

16 *See* William A. Klein & John C. Coffee, Jr., Business Organization and Finance: Legal and Economic Principles 103 (8th ed. 2002) (stating that "nonparticipation in . . . control . . . may be desirable" because "limited partner[s] may actually find comfort in the fact that decisions relating to management of the business will not be in the hands of people as inexperienced as himself").

17 *See* Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. Chi. L. Rev. 187, 204 (1991).

18 Sample v. Morgan, 914 A.2d 647, 664 (Del. Ch. 2007) ("Stockholders can entrust directors with broad legal authority precisely because they know that the authority must be exercised consistently with equitable principles of fiduciary duty.").

19 Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 927–28 (Del. 2003).

20 Del. Code. Ann. tit. 8, § 211(a)(1) (2024).

21 *Id.* § 142.

22 *Id.* § 212.

23 *Id.* § 220.

24 Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939).

25 *See* Miners' Ditch Co. v. Zellerbach, 37 Cal. 543, 577 (1869).

26 *See, e.g.*, Sargent v. Franklin Ins. Co., 25 Mass. (8 Pick.) 90, 96 (1829); Gilbert v. Manchester Iron Mfg. Co., 11 Wend. 627, 628 (N.Y. Sup. Ct. 1834).

supposedly inadequate consideration.[27] In one case, two brothers fraudulently induced their deceased sibling's widow to dissolve a company in which she owned stock, even as the brothers planned to continue the business via a newly created company.[28] From this, one can see that many modern dilution claims are analogous to these traditional claims, where it was not that a corporation's underlying assets were squandered by mismanagement but rather that the shareholder's equitable claims to those assets—their stock—were wrongfully converted or destroyed.

However, given management's control of the corporation's assets, management need not directly mishandle shareholders' stock to misappropriate the capital that shareholders entrust to management. More subtly, management can mismanage the assets of the corporation. The shareholder's stock, insofar as it represents a residual claim on the value of the corporation, is consequently devalued derivatively.

Hence, courts began to recognize that "in a court of equity[,] . . . a stockholder may sue in his own name for the purpose of enforcing corporate rights."[29] As one court wrote, a shareholder had:

> [A] right to call to account his directors for their management of the corporation, analogous to the right of a trust beneficiary to call his trustee to account for the management of the trust corpus. The stockholder's right was therefore individual, although the interest he sought to protect was primarily that of the corporation and only indirectly his own.[30]

For example, some of the first American derivative suits alleged that directors improperly used corporate funds for stock market speculation,[31] that officers used corporate funds to benefit another corporation,[32] or that directors leased corporate property to themselves at unfair rates.[33]

Likewise, the early English case *Hichens v. Congreve*[34] alleged that managers overcharged a company for a lease and sought to compel the return of the overcharge to the company.[35] Thereafter, courts also began

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27 *See, e.g.*, Stebbins v. Perry County, 47 N.E. 1048, 1050 (Ill. 1897); Kimball v. New Eng. Roller-Grate Co., 45 A. 253, 254 (N.H. 1899); Luther v. C.J. Luther Co., 94 N.W. 69, 72 (Wis. 1903).

28 Vogt v. Vogt, 104 N.Y.S. 164, 165 (App. Div. 1907).

29 Sohland v. Baker, 141 A. 277, 281 (Del. 1927); Dodge v. Woolsey, 59 U.S. (18 How.) 331, 343 (1855); *see also* Scarlett, *supra* note 15, at 873.

30 Maldonado v. Flynn, 413 A.2d 1251, 1261 (Del. Ch. 1980), *rev'd on other grounds sub nom.* Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981).

31 *E.g.*, Robinson v. Smith, 3 Paige Ch. 222, 223 (N.Y. Ch. 1832). *Robinson* has been regarded as the first American derivative suit. Prunty, *supra* note 15, at 986; Scarlett, *supra* note 15, at 873.

32 *E.g.*, Hodges v. New Eng. Screw Co., 1 R.I. 312, 315–16 (1850).

33 *E.g.*, Brewer v. Proprietors of the Bos. Theatre, 104 Mass. 378, 379 (1870). For further examples of early American derivative suits, see Scarlett, *supra* note 15, at 872–84.

34 (1828) 39 Eng. Rep. 58, 58; 1 Russ & M. 150, 150.

35 *Id.*

allowing shareholders to sue third parties that were at arm's length with the corporation, such as tax collectors[36] and fraudsters.[37]

Yet as courts have long recognized, such suits alleging mismanagement necessarily infringe upon "the discretion of directors to manage a corporation without undue interference"[38] and also invite abuse.[39] For example, if Foxconn breaches a contract with Apple, there would be utter chaos if any Apple shareholder could then sue Foxconn—a major supplier of Apple[40]—for issues that Apple's management might choose to otherwise ignore or waive. Neither would it do to move the issue up one level by allowing an Apple shareholder to sue Apple management on a theory of breach of fiduciary duty for failing to pursue a suit against Foxconn. Abused in this way, a derivative suit could ensnare a corporation in an unproductive or outright destructive tangle of litigation—or more likely, be used to extort a corporation into paying blackmail to end the litigation. Likewise, in the early era of the derivative suit, shareholders and corporations colluded to have a shareholder derivatively assert breach of contract claims on behalf of the

36 *E.g.*, Dodge v. Woolsey, 59 U.S. (18 How.) 331, 335 (1855).

37 *See, e.g.*, Forbes v. Whitlock, 3 Edw. Ch. 446, 447 (N.Y. Ch. 1841).

38 *See* Marx v. Akers, 666 N.E.2d 1034, 1037 (N.Y. 1996).

39 Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, 95–96 (1991); *see also* Andrew C.W. Lund, *Rethinking* Aronson*: Board Authority and Overdelegation*, 11 U. Pa. J. Bus. L. 703, 713–15 (2009). Other reasons have also been given for why shareholders cannot directly assert corporate causes of action and must instead proceed derivatively:

> (1) The corporation is a separate entity, and the shareholder does not have a legal interest in its property. (2) Multiplicity of suits by individual shareholders will be avoided. (3) Impairment to creditors' rights will be avoided, since the recovery will belong to the corporation. (4) Corporate recovery benefits all shareholders equally.

9 Mark Kaufman, Julian A. Fortuna, Timothy Igo & James M. Lawniczak, Business Organizations with Tax Planning § 119.01 (2024) (footnotes omitted). However, each of these reasons are unconvincing. First, the notion that shareholders should not be permitted to assert corporate claims merely because of the legal formalism separating the corporation from its shareholders would also undermine the equitable basis for the derivative suit. Second, multiple direct claims can easily be handled instead as a class action with no meaningful difference in judicial burden as compared with a derivative suit. John W. Welch, *Shareholder Individual and Derivative Actions: Underlying Rationales and the Closely Held Corporation*, 9 J. Corp. L. 147, 165–66 (1984) (giving reasons why the creditor protection and lawsuit congestion arguments are flawed). Third, it is far from clear why a doctrine with multifaceted and far-ranging implications is necessary to protect creditors who are already protected by contract. Moreover, a court of equity has more than ample power to protect creditors from underhanded litigation strategy. *Id.* Fourth, that "[c]orporate recovery benefits all shareholders equally" is as likely to be a negative given that corporate wrongdoing often benefits some shareholders at the expense of others and, furthermore, does not give reason to treat the claim as derivative because courts can readily award pro rata or corporate recoveries even for direct claims. *See* Kaufman et al., *supra*; *infra* Section II.B.1.

40 Laura He, *Apple iPhone Maker Foxconn Being Investigated in China as Founder Runs for Taiwan Presidency*, CNN (Oct. 23, 2023, 5:43 AM), https://www.cnn.com/2023/10/23/economy/china-foxconn-investigation-taiwan-presidency-intl-hnk/index.html [https://perma.cc/PP56-DURQ].

corporation to create diversity jurisdiction.[41] Accordingly, courts contemporaneously imposed significant procedural hurdles—such as the demand requirement—upon derivative claims,[42] bridling the potential for abuse of the shareholder suit in such contexts.

Around the turn of the 20th century, courts began consciously distinguishing between direct and derivative actions[43] and, upon doing so, they noted that plaintiffs pressing a direct claim were not required to satisfy procedural hurdles such as the demand requirement, which only applied to derivative claims.[44] Although several of these opinions rest on a facially sensible but, as will be shown, readily manipulable distinction between corporate and personal shareholder interests,[45] a few decisions went further in their analyses.

Those decisions showed that an important part of what made a personal shareholder interest "personal" was the shareholder's participatory right in corporate governance.[46] As explained by the New York Court of Appeals in the 1906 case *Stokes v. Continental Trust Co. of New York*,[47] these rights must be vigorously protected by courts because they are the primary means by which shareholders protect themselves outside of the courts:

> [Stockholders have] the right to vote for directors and upon all propositions subject by law to the control of the stockholders, and this is [their] supreme right and main protection. Stockholders

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41 *See* Donna I. Dennis, *Contrivance and Collusion: The Corporate Origins of Shareholder Derivative Litigation in the United States*, 67 Rutgers U. L. Rev. 1479, 1486–1515 (2015); 7C Charles Alan Wright, Arthur R. Miller, Mary Kay Kane & Allan Stein, Fed. Prac. & Proc. Civ. § 1830 (3d ed. 2024).

42 Although *Robinson v. Smith* has long been regarded as the first American derivative suit, *see supra* note 31, it has seemingly received less attention for what appears to be the first (or, at least, among the first) articulations of a demand requirement or demand futility rule:

> Generally, where there has been a waste or misapplication of the corporate funds, by the officers or agents of the company, a suit to compel them to account for such waste or misapplication should be in the name of the corporation. But as this court never permits a wrong to go unredressed merely for the sake of form, *if it appeared that the directors of the corporation refused to prosecute by collusion with those who had made themselves answerable by their negligence or fraud*, or if the corporation was still under the control of those who must be made the defendants in the suit, the stockholders, who are the real parties in interest, would be permitted to file a bill in their own names, making the corporation a party defendant.

Robinson v. Smith, 3 Paige Ch. 222, 233 (N.Y. Ch. 1832) (emphasis added).

43 *See, e.g.*, Shaw v. Staight, 119 N.W. 951, 954–55 (Minn. 1909); Witherbee v. Bowles, 95 N.E. 27, 28–29 (N.Y. 1911); White v. First Nat'l Bank of Pittsburgh, 97 A. 403, 405 (Pa. 1916).

44 Dousman v. Wis. & Lake Superior Mining & Smelting Co., 40 Wis. 418, 422 (1876); Stebbins v. Perry County, 47 N.E. 1048, 1051 (Ill. 1897).

45 *Shaw*, 119 N.W. at 954; *Dousman*, 40 Wis. at 422; *Witherbee*, 95 N.E. at 28.

46 *See, e.g.*, Luther v. C. J. Luther Co., 94 N.W. 69, 73 (Wis. 1903); *cf. Stebbins*, 47 N.E. at 1050–51 (noting the impairment of voting rights).

47 78 N.E. 1090 (N.Y. 1906).

> have no direct voice in transacting the corporate business, but through their right to vote they can select those to whom the law [e]ntrusts the power of management and control.[48]

Indeed, absent an interference with their governance rights, shareholders must instead resort to those rights when they have grievances and not the courts:

> This right to vote for directors, and upon propositions to increase the stock or mortgage the assets, is about all the power the stockholder has. So long as the management is honest, within the corporate powers, and involves no waste, the stockholders cannot interfere, even if the administration is feeble and unsatisfactory, but must correct such evils through their power to elect other directors. Hence, the power of the individual stockholder to vote in proportion to the number of his shares is vital . . . .[49]

As these insightful words show, one important basis for the ease of bringing some claims—particularly those relating to governance rights—and not others is the relationship between the right to judicial redress and shareholders' other corporate governance rights. When other governance avenues are still clear, courts are understandably reluctant to insert themselves into internal corporate disputes. But if the misconduct directly undermines those governance mechanisms, then a court must interpose itself to protect shareholders against harm.

Additionally, as courts have also acknowledged, a recognition of courts' relative competencies also calls for judicial restraint as to matters of business judgment. When ruling on the economic merits of a shareholder suit, "the court substitutes its judgment *ad hoc* for that of the directors in the conduct of its business."[50] Yet this power must be "exercised with restraint,"[51] as overreach "would expose directors to substantive second guessing by ill-equipped judges or juries, which would, in the long-run, be injurious to investor interests."[52]

These two factors—the availability of alternative governance rights and judicial competence—form the normative foundations of the law on the direct-derivative distinction, whatever legal test nominally applies. And on the easiest cases, all extant legal tests governing the

48 *Id.* at 1093.

49 *Id.*

50 Gordon v. Elliman, 119 N.E.2d 331, 335 (N.Y. 1954).

51 *Id.*

52 *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967 & n.15 (Del. Ch. 1996) (contrasting the Delaware position with that espoused by the American Law Institute, which stated that for a decision "to qualify for" judicial deference under the "business judgment [rule], a director must [have] 'rationally' believe[d] that the [business judgment] is in the best interests of the corporation" (quoting AM. L. INST., PRINCIPLES OF CORP. GOVERNANCE § 4.01(c) (1994))).

distinction between these two types of claims reach the same sensible results: when shareholders press claims of mismanagement of corporate assets, such claims are usually considered derivative. On the other hand, when shareholders press claims regarding voting rights and inspection rights, such claims are considered direct. But when the facts become more challenging, the current law often loses its footing.

B. The Tooley *Test and Its Application*

Decided in 2004, *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.* laid down the current test for determining whether a shareholder claim is direct or derivative.[53] Before *Tooley*, the supposedly controlling test for whether a claim was direct or derivative flowed from the 1953 case *Elster v. American Airlines*,[54] which asked whether the plaintiff had suffered a "special injury."[55] However, the "special injury" test was plagued with issues over the years, particularly in cases in which shareholders were direct participants in the transaction, as might be the case in, say, a buyout.[56] Furthermore, as *Tooley* noted, *Elster* never even defined the term "special injury."[57] But despite claiming to discard the old "special injury" test, *Tooley* was in fact a refinement of that test. Indeed, *Tooley* expressly sought to position itself as inspired by the same principles that motivated the "special injury" test.[58] In any event, *Tooley* framed the test as thus:

> [W]hether a stockholder's claim is derivative or direct. . . . turn[s] 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)?[59]

Many states expressly follow *Tooley*.[60] Yet even among the states that have not expressly adopted *Tooley* (or have even outright rejected aspects of *Tooley*), the law of such states still often follows the outlines of *Tooley* by examining who suffered the harm and who is entitled to

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53 Tooley v. Donaldson, Lufkin, & Jenrette, Inc., 845 A.2d 1031, 1035 (Del. 2004).

54 100 A.2d 219 (Del. Ch. 1953).

55 *Id.* at 222.

56 *See, e.g.*, Kramer v. W. Pac. Indus., Inc., 546 A.2d 348, 352–53 (Del. 1988).

57 *Tooley*, 845 A.2d at 1037 (quoting *Elster*, 100 A.2d at 222).

58 *See id.* at 1035 (claiming that the principles of the *Tooley* test are "well imbedded in our jurisprudence").

59 *Id.* at 1033 (emphasis omitted).

60 *See, e.g.*, Murphy v. Inman, 983 N.W.2d 354, 369–70 (Mich. 2022); Parametric Sound Corp. v. Eighth Jud. Dist. Ct., 401 P.3d 1100, 1102 (Nev. 2017); Corwin *ex rel.* Beatrice Corwin Living Irrevocable Tr. v. Brit. Am. Tobacco PLC, 821 S.E.2d 729, 735 (N.C. 2018); Keller v. Est. of McRedmond, 495 S.W.3d 852, 875–77 (Tenn. 2016); Yudell v. Gilbert, 949 N.Y.S.2d 380, 381 (App. Div. 2012).

the benefit of a recovery.[61] For instance, Minnesota, which has expressly rejected *Tooley*, nevertheless "distinguishes direct from derivative claims by identifying who suffered the injury and therefore who is entitled to the recovery for that injury."[62] And American jurisdictions that have not expressly rejected *Tooley* but supposedly do not follow *Tooley*'s principles are often just relying on pre-*Tooley* Delaware caselaw or similarly structured rules.[63]

Although *Tooley* promised clarity by moving past the old "special injury" test, the years following *Tooley* were plagued with further confusion. In particular, courts struggled with claims of "dilution" and "overpayment," terms that the Delaware courts use interchangeably.[64] In "dilution" or "overpayment" claims, shareholders argue that they suffered direct financial harm due to some misconduct regarding a transaction involving stock or corporate assets, while defendants argue that any financial harm to shareholders arose only as a result of financial harm to the corporate entity.[65] The post-*Tooley*, pre-*Brookfield* caselaw

61 *See, e.g.*, Nickell v. Shanahan, 439 S.W.3d 223, 227 (Mo. 2014) (en banc); *see* Am. Jur. 2d *Corporations* § 1923 (2024).

62 *In re* Medtronic, Inc. S'holder Litig., 900 N.W.2d 401, 409 (Minn. 2017); *accord* Int'l Bhd. of Elec. Workers Loc. No. 129 Benefit Fund v. Tucci, 70 N.E.3d 918, 926–27 (Mass. 2017) (rejecting *Tooley* but nevertheless holding that claims of inadequate merger price are derivative because the stockholder was injured only as a result of injury to the firm).

63 *See, e.g.*, Eastland Food Corp. v. Mekhaya, 301 A.3d 308, 331–32 (Md. 2023); Notz v. Everett Smith Grp., Ltd., 764 N.W.2d 904, 911 (Wis. 2009); Strasenburgh v. Straubmuller, 683 A.2d 818, 829 (N.J. 1996); Grace Bros., Ltd. v. Farley Indus., Inc., 450 S.E.2d 814, 816 (Ga. 1994); Dinuro Invs., LLC v. Camacho, 141 So. 3d 731, 739–40 (Fla. Dist. Ct. App. 2014); Altrust Fin. Servs., Inc. v. Adams, 76 So. 3d 228, 246 (Ala. 2011); Elizabeth J. Thompson, Note, *Direct Harm, Special Injury, or Duty Owed: Which Test Allows for the Most Shareholder Success in Direct Shareholder Litigation?*, 35 J. Corp. L. 215, 235 (2009) (noting that with one "small exception, in application it makes little difference which test a court applies because . . . the end results are most often the same").

64 *See, e.g.*, Brookfield Asset Mgmt., Inc. v. Rosson, 261 A.3d 1251, 1266–67, 1275 (Del. 2021) ("We think that when a corporation exchanges equity for assets of a stockholder who is already a controlling stockholder for allegedly inadequate consideration, the dilution/overpayment claim is exclusively derivative. . . . [H]olding 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. . . . We agree that there is no principled reason to allow dilution/overpayment claims to proceed directly against controllers . . . ."); El Paso Pipeline GP Co. v. Brinckerhoff, 152 A.3d 1248, 1265 n.2 (Del. 2016) (Strine, C.J., concurring) ("Classically, Delaware law has viewed as derivative claims by shareholders alleging that they have been wrongly diluted by a corporation's overpayment of shares." (quoting Green v. LocatePlus Holdings Corp., No. 4032-CC, 2009 WL 1478553, at *2 (Del. Ch. May 15, 2009))); Feldman v. Cutaia, 951 A.2d 727, 732 (Del. 2008) ("[D]ilution claims are 'not normally regarded as direct, because any dilution in value of the corporation's stock is merely the unavoidable result (from an accounting standpoint) of the reduction in the value of the entire corporate entity, of which each share of equity represents an equal fraction.' In the absence of a controlling stockholder, 'such equal "injury" to the [company's] shares resulting from a corporate overpayment is not viewed as, or equated with, harm to specific shareholders individually.'" (footnotes omitted) (quoting Gentile v. Rossette, 906 A.2d 91, 99 (Del. 2006))).

65 *See infra* Sections III.A–.B.

in Delaware made contradictory statements regarding whether these claims should be accorded direct or derivative treatment.[66] Nor did it help when other judicial statements suggested that plaintiffs may bring both direct and derivative claims.[67]

Brookfield promised to end the "doubt" and provide "certainty" regarding the treatment of such claims.[68] Applying *Tooley*, *Brookfield* held that "overpayment/dilution . . . claims . . . are exclusively derivative" because they "deprive[] the corporation of assets."[69] In further support, *Brookfield* reiterated the problems with the old "special injury" test, claimed that there is a "general rule that equity dilution claims are solely derivative," and argued that to allow such claims to proceed directly would invite practical difficulties given that other legal claims already allow recovery for the injuries complained of.[70]

However, there are serious problems with both *Tooley* and *Brookfield*'s application of it. This Article next turns to the analytical issues with *Tooley* and its progeny, including *Brookfield*, and explains why they fail to produce an orderly and coherent system for distinguishing between direct and derivative claims.

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66 *Infra* Section III.B.

67 *See, e.g.*, San Antonio Fire & Police Pension Fund v. Bradbury, No. 4446-VCN, 2010 WL 4273171, at *9 n.71 (Del. Ch. Oct. 28, 2010).

68 *Brookfield*, 261 A.3d at 1275, 1280.

69 *Id.* at 1277. A recent law review article titled Tooley *Brooks No Exceptions—Equity Dilution Is Direct* critiqued *Brookfield* as inconsistent with *Tooley*. Chen & Zhou, *supra* note 15, at 26–27. However, as this Article argues, *Tooley* has far more fundamental issues such that merely reconciling *Brookfield* with *Tooley* would be akin to mopping the floor under a leaky roof. Moreover, without carefully considering the issues that *Tooley* sensibly tries to avoid, any proposed solution might unintentionally create more problems than it resolves. For example, *No Exceptions* argues that courts should allow dual-natured claims when entities use stock and cash to purchase assets. *Id.* at 41–43. This, however, would suggest that direct claims could exist in any dispute involving stock compensation and that even banal compensation disputes with corporate officers paid with stock could lead to direct shareholder claims against those officers. *See id.* at 43–44. Such would be a strange and chaotic result to say the least. *See infra* notes 330–31 and accompanying text. Furthermore, *No Exceptions*' approach would seem to disincentivize executive stock compensation (subject to a direct claim) in favor of cash compensation (subject only to a derivative claim), *see* Chen & Zhou, *supra* note 15, at 44, 48, quite the opposite of accepted good governance practices. Likewise, *No Exceptions* penalizes mergers that are transacted with stock rather than cash, as the fiduciaries of the purchaser would be subject to direct claims when the deal is done with stock (or a mix of stock and cash) and derivative claims when the deal is done with only cash. *See id.* at 45–46. No policy rationale is given for this disparity, and it is hard to imagine one. *See id.* Finally, *No Exceptions* elides the issue of what claims would be available if the defendants do not directly owe a duty to shareholders, as would be the case if, for example, a third-party contractor breaches an otherwise fair agreement involving a transfer of stock as consideration. *Cf. infra* notes 311–13 and accompanying text.

70 *Brookfield*, 261 A.3d at 1269–77.

II. The Intractability of the Current Distinction

There are multiple analytical issues with the current direct-derivative paradigm under *Tooley* that lead to abuse and inefficiency. First—and most importantly—both prongs of *Tooley* look to questions that cannot be definitively answered or, when they can be answered, the answer varies depending on formalistic, questioning-begging characterizations of transactions with identical or near-identical underlying economics. Second, *Tooley* contains an internal inconsistency due to courts' conflation of the terms "overpayment" and "dilution."[71] Although *Tooley* purports to treat claims as derivative when the corporation suffers a harm or injury and treats "dilution" claims as accordingly derivative, many "dilution" claims in fact involve no corporate harm.

A. The Intractability of the Harm Test

The first prong of *Tooley* asks "who suffered the alleged harm."[72] Under *Tooley*, injuries suffered by the shareholder alone give rise to direct claims, and injuries suffered by the corporation first and by the shareholder only "derivative[ly]" give rise to derivative claims.[73] This aspect of *Tooley* is akin to one of the original formulations of the distinction between direct and derivative claims: whether the alleged injury enforces a right held personally and solely by shareholders or a right formally held by the corporation and enforced derivatively by shareholders.[74] But as this Section demonstrates, "who suffered the alleged harm [or injury]"[75] is readily manipulable as to economic injuries, and even as to noneconomic injuries, it is often debatable whether an alleged harm affects a corporation.

1. The Indeterminacy of the Locus of Economic Harms

Issues often arise under *Tooley* when evaluating the impact of economic harms or injuries. This is because *Tooley*'s examination of the locus of economic harm turns on the legal formalities of the transaction at issue, even though economically identical results may occur via different formalities.[76] As such, *Tooley* treats transactions differently depending on how the transaction is legally structured, especially when self-dealing is involved, even if the transactions result in identical economic results. Several examples serve to illustrate the point.

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71 *See supra* note 64 and accompanying text.

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

73 *See id.* at 1039.

74 *See supra* notes 29–30, 45 and accompanying text.

75 *Tooley*, 845 A.2d at 1033.

76 *See id.* at 1039.

Consider a Corporation X, which has an equity value of $10 million, half of which is held by a controlling shareholder and the other half of which is held by a number of dispersed minority shareholders. Now, consider three potential transactions:

1. The controller causes Corporation X to pay $2 million for a worthless asset that he owns and then, using the $2 million in proceeds, purchases another $2 million of newly issued shares from the corporation at fair market value ("Transaction 1").
2. The controller causes Corporation X to issue additional shares to the controller themselves for worthless consideration such that the controller holds 60% of Corporation X's equity afterward ("Transaction 2").
3. The controller causes Corporation X to cancel a sufficient number of minority shares such that the controller holds 60% of Corporation X's equity afterward ("Transaction 3").

Each of these transactions results in the same economic outcome:[77] the post-transaction Corporation X has $10 million in equity value, 60% of which is held by the controller and 40% of which is held by minority shareholders. And because each of these three transactions are economically identical, it would make little sense if claims arising out of one of these transactions were considered derivative while claims arising out of another were considered direct; indeed, as argued in Section IV.A.2, *infra*, claims relating to any of these transactions should be treated as direct claims.

Yet *Tooley* would treat claims arising out of these transactions differently.[78] *Tooley* would treat Transaction 1 as a derivative "overpayment" or "dilution" case. The treatment of Transaction 2 was disputed by some of the post-*Tooley* caselaw, but *Brookfield* makes clear that Transaction 2 would also give rise to a derivative claim.[79] Transaction 3, on the other hand, gives rise to a direct claim under *Tooley*: the corporation has suffered no harm and the only harm is to the minority who had their shares outright canceled.

Take another example, this time concerning a merger between Corporation A and Corporation B, which have the same controlling

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77 For analytical clarity, we can easily eliminate any changes to voting rights in the three transactions. For example, the newly issued shares in Transactions 1 and 2 may be nonvoting stock and the controller could increase the per share voting rights of the minority shareholders in Transaction 3.

78 *See* Itai Fiegenbaum, *The Controlling Shareholder Enforcement Gap*, 56 AM. BUS. L.J. 583, 611–12 (2019) (explaining how a variety of claims like Transactions 1, 2, and 3 are treated differently under the *Tooley* test).

79 *See* Brookfield Asset Mgmt., Inc. v. Rosson, 261 A.3d 1251, 1266 (Del. 2021).

shareholder, although A also has minority investors.[80] Corporation A has an equity value of $1 billion, which consists entirely of cash, with one million shares outstanding. Corporation B has an equity value of $500 million with 500,000 shares outstanding. The controller engineers one of the following transactions:

1. Corporation A pays $1 billion in cash for Corporation B ("Transaction 4").
2. Corporations A and B merge in a stock-for-stock merger with Corporation A as the surviving entity, with each share of Corporation B being converted into four shares of Corporation A at closing ("Transaction 5").
3. Corporations A and B merge in a stock-for-stock merger with Corporation B as the surviving entity, with each share of Corporation A being converted into 0.25 shares of Corporation B at closing ("Transaction 6").
4. Corporation A's minority shareholders are squeezed out at $500 cash per share ("Transaction 7").

In all four transactions, Corporation A's minority shareholders were deprived of half of their stock's economic value. Nevertheless, once again, *Tooley* would treat the transactions differently. With Transactions 4 and 5, Corporation A shareholders can only pursue derivative "overpayment" claims.[81] Yet with Transaction 7, Corporation A's minority shareholders unquestionably should be able to pursue a direct claim for inadequate merger consideration under *Tooley*.[82] Similarly, Transaction 6 should lead to direct inadequate merger consideration claims under *Tooley* as well.[83]

Pre-merger misconduct relating to so-called "golden parachutes" also presents an issue in the *Tooley* paradigm.[84] For example, if manage-

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80 The principle of this example is drawn from *In re* El Paso Pipeline Partners, L.P. Derivative Litig., 132 A.3d 67, 109–10 (Del. Ch. 2015), *rev'd sub nom.* El Paso Pipeline GP Co. v. Brinckerhoff, 152 A.3d 1248 (Del. 2016).

81 *Id.* at 1261; *Brookfield*, 261 A.3d at 1266; *see also* Ams. Mining Corp. v. Theriault, 51 A.3d 1213, 1265 (Del. 2012) (Berger, J., concurring in part and dissenting in part). One commentator noted the potential impact on creditors in Transaction 1 because the value of Corporation A is reduced. *See supra* note 39. But, as noted elsewhere in this Article, that Transaction 1 might in fact be some sort of fraudulent transfer intended to harm creditors can be resolved by, among other things, treating the claim as a direct claim for procedural purposes but crafting a final remedy that goes to the corporation or permitting creditors to press a claim against the controller for fraudulent transfer. *See supra* note 42.

82 *See In re* Orbit/FR, Inc. S'holders Litig., No. 2018-0340-SG, 2023 WL 128530, at *3–4 (Del. Ch. Jan. 9, 2023) (allowing a direct claim for inadequate merger consideration in a squeeze-out).

83 *See* Morris v. Spectra Energy Partners (DE) GP, LP, 246 A.3d 121, 124, 136–39 (Del. 2021) (allowing a direct claim for inadequate merger consideration in a merger where the suing equity owner's holdings were converted into equity of surviving entity).

84 *See, e.g.*, Parnes v. Bally Ent. Corp., 722 A.2d 1243, 1245 (Del. 1999).

ment successfully demands a $100 million bribe from an acquirer to ease along a merger sale,[85] that cannot help but suggest that shareholders were deprived of the just fruits of their equity ownership without any concomitant harm or injury to the corporation, which in turn suggests that any legal claim for inadequate merger consideration should be treated as direct. After all, this was the holding of the *Parnes v. Bally Entertainment*[86] decision.[87] But suppose management instead causes the corporation to enter into employment contracts that pay $100 million in bonuses to the managers themselves upon the sale of the corporation to an acquirer and then closes an acquisition. Delaware Supreme Court decisions in *Lewis v. Anderson*[88] and *Kramer v. Western Pacific Industries*[89] held that claims arising out of such dealings were derivative, as shareholder harm from such contracts, which are between the corporation and management, flowed derivatively from harm to the corporation.[90] Yet what is the meaningful difference between management stating that "any acquirer has to pay us $100 million for us to agree to a deal" and "we're giving ourselves contracts where, if any acquirer buys us, we get $100 million"?[91]

In the extreme example, a corporation can rework a simple contract with a third party for goods or services that would allow for a shareholder to bring a direct claim, even though actual shareholder suits over such contracts are universally treated as derivative. This is because ordinary business-to-business contracts usually exchange cash from a corporation's corporate treasury for goods or services from the contractual counterparty, or vice versa, in which the corporation receives cash in exchange for providing goods or services. The shareholders of the corporation can only allege that the corporation gave too much cash, or goods or services, in exchange for the consideration provided, hence devaluing the corporation and the shareholders derivatively. However, instead of paying cash for goods and services, a corporation could also, say, issue a single share of common stock to the counterparty and then announce a dividend specific to that share equal to the amount of cash it would have paid, reduced, perhaps, by the market value of the share issued. Because other shareholders of the same class would not have received similar dividends for

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85 *See infra* note 229 and accompanying text; Andrew Ross Sorkin, *Those Sweet Trips to the Merger Mall*, N.Y. TIMES, Apr. 7, 2002, at 12 ("Publicly, we have to call these things retention bonuses. Privately, sometimes it's the only way we would have got the deal done. It's a kickback." (quoting Interview with anonymous "well-known merger lawyer")).

86 722 A.2d 1243 (Del. 1999).

87 *Id.* at 1245.

88 477 A.2d 1040 (Del. 1984).

89 546 A.2d 348 (Del. 1988).

90 *See infra* notes 207–14 and accompanying text.

91 The Coase Theorem teaches that the formal source of the funds—the acquirer in the former case, the corporation in the latter—is irrelevant to the actual economic impact. *See* R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 387 (1937).

their shares, those shareholders theoretically would be entitled to press a direct claim for treating shares of the same class differently.[92] But, of course, the substantive economics of the regular cash-for-services contract is the same as the share-plus-special-dividend-for-services contract.

It does not suffice to respond that no intelligent corporate manager would arrange a transaction whereby a supplier is paid via a *sui generis* dividend—not the least because of the increased litigation risk. The problem is that intelligent corporate managers would, and do, rearrange other transactions that would give rise to direct claims into forms that instead give rise to derivative claims. Such rearrangements create transaction and agency costs, frustrate the underlying policy purposes behind distinguishing between direct and derivative claims, and lead to inefficiency and injustice.

Before moving on, note that although the discussion above is centered around *Tooley*, non-*Tooley* tests used by other courts suffer from similar issues—the problems discussed in this Section are common to essentially all extant direct-derivative tests because they all conceive of common corporate wrongs as resulting in injuries that flow from the corporation to the shareholders. For example, courts not applying *Tooley* also treat overpayment claims as derivative[93] and wrongful transfers of stock from a minority to the controller as direct claims.[94] But, as illustrated above, an overpayment-and-repurchase scheme can replicate the economics of a wrongful transfer.

2. *The Indeterminacy of the Locus of Noneconomic Harms*

Although the problems of indeterminacy are most significant in the economic harm context, they can also arise with noneconomic injuries because a corporation as an entity often has interests aligned with the interests of individual shareholders.

For example, consider a books-and-records case. Although the right to books-and-records theoretically runs directly to shareholders,[95] it is also true that in many states, including Delaware, directors owe fiduciary duties to shareholders as well as the corporation.[96] Yet, though shareholders may universally press books-and-records cases as

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92 Notz v. Everett Smith Grp., Ltd., 764 N.W.2d 904 (Wis. 2009) (allowing a direct claim where the majority shareholder received a de facto dividend that the minority did not receive as an injury "primarily . . . to an individual shareholder" (quoting Jorgensen v. Water Works, Inc., 630 N.W.2d 230 (Wis. Ct. App. 2001))); Hanson v. Kake Tribal Corp., 939 P.2d 1320, 1328 (Alaska 1997); *cf.* Colon v. Bumble, Inc., 305 A.3d 352, 369, 372 (Del. Ch. 2023).

93 *See, e.g.*, Bessette v. Bessette, 434 N.E.2d 206, 208 (Mass. 1982).

94 *See, e.g.*, Wilson v. H.J. Wilson Co., 430 So. 2d 1227, 1234 (La. Ct. App. 1983).

95 *Supra* note 23 and accompanying text.

96 1 Phillip J. Campanella, Philip J. Crihfield, David C. Forsberg & Mary Hutchins Reed, Business Torts § 2.01 (Joseph D. Zamore ed., 2024).

direct claims, shareholders often must pursue breach-of-fiduciary-duty claims against directors as derivative claims.[97] Nevertheless, in books-and-records cases predicated upon corporate mismanagement, it is presumed that the release of the documents may aid in redressing the harm to the corporation.[98] But then does the withholding of relevant documents not also harm the corporation, with harm to the shareholder flowing from the harm to the corporation? And if that is the case, why is a shareholder not required to allege demand futility when seeking books and records relevant to suspected misconduct? Similarly, when a claim challenges a board's improper entrenchment—a claim that is usually treated as direct—does the corporation not also have an interest in avoiding improperly entrenched managers?[99] And if not, then whence arises the corporate interest in seeking redress for other types of managerial or financial misconduct?

B. The Intractability of the Remedy Test

The second prong of *Tooley*, which asks whether the remedy would go to the corporation or to shareholders,[100] is also an indeterminate question for two reasons. First, for any given harm, different remedies can reach similarly equitable results. Second, the impact of many remedies is either hard to determine or reaches beyond the nominal beneficiary of the remedy. In particular, remedies aiming to solely benefit shareholders also often benefit corporations, raising the same policy issues that underlie why boards generally control the corporation's litigation against third parties.

1. The Choice of Remedy

Perhaps obviously, a court's choice of remedy affects who receives the remedy. This would be no issue if there was a one-to-one relationship between injuries and remedies, but no such relationship exists. As Vice Chancellor Laster has noted, "a court of equity can award a stockholder-level remedy for a derivative claim."[101] As this Section shows, not only is

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97 *See, e.g.*, Quadrant Structured Prods. Co. v. Vertin, 102 A.3d 155 (Del. Ch. 2014).

98 *See, e.g.*, Emps.' Ret. Sys. of R.I. v. Facebook, Inc., No. 2020-0085, 2021 WL 529439, at *2–4 (Del. Ch. Feb. 10, 2021).

99 *Cf.* Gordon v. Elliman, 119 N.E.2d 331, 338 (N.Y. 1954).

100 *Supra* text accompanying note 59.

101 New Enter. Assocs. 14, L.P. v. Rich, 292 A.3d 112, 156 n.27 (Del. Ch. 2023); *see also* Goldstein v. Denner, No. 2020-1061-JTL, 2022 WL 1797224, at *15–20 (Del. Ch. June 2, 2022). Vice Chancellor Laster concludes that "the court's remedial flexibility means that the second prong of *Tooley* does not play much of a role in the analysis" and that "[t]he characterization of the injury in the first prong dominates the outcome." *New Enter. Assocs. 14*, 292 A.3d at 156 n.27. However, as this Article points out, the characterization of the injury is likewise malleable, if not by the court, then by the plaintiff.

Vice Chancellor Laster correct, but the reverse is also true—courts can often equitably award corporation-level remedies for direct claims.

For example, consider a classic overpayment scheme, such as that discussed in the Corporation X scenario in Section II.A.1 above, in which a controlled corporation paid too much for a separate controller-held asset. As a remedy, a court could order the controller to repay the corporation the amount of the overpayment, suggesting that the claim is derivative.[102] But it would be equally equitable for the court to either cancel a sufficient amount of the controller's stock such that the corporation's per share equity value was restored to the status quo ante or order the controller to pay the minority shareholders a sufficient amount to compensate them for the losses in the value of their stockholdings. Although the first remedy would suggest that the claim is derivative under the second prong of *Tooley*, either of the latter two remedies would suggest a direct claim.[103]

Similarly, in transactions in which a controller issued additional shares for inadequate consideration, there can be multiple equitable remedies. One may be that the controller is ordered to pay the corporation the difference between the pretransaction fair market value of the shares and the amount actually paid to the corporation, suggesting that the claim is derivative. Another might be to cancel the wrongfully issued shares.[104] And yet a third may be to order that each minority shareholder similarly receive additional shares for each original share held or that the controller directly pay each minority shareholder for the loss in value of each original share the minority held, either suggesting that the claim is direct.[105]

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102 Note that the concerns that "an entity-level recovery would benefit 'guilty' stockholders," *In re* El Paso Pipeline Partners, L.P. Derivative Litig., 132 A.3d 67, 124 (Del. Ch. 2015), *rev'd sub nom.* El Paso Pipeline GP Co. v. Brinckerhoff, 152 A.3d 1248 (Del. 2016), do not really apply so long as the court has jurisdiction over the "'guilty' stockholders" and can order all of them to contribute to the entity-level recovery. Consider, for instance, the "'guilty' stockholder" in the example discussed above who wrongfully increased his ownership of a $10 million firm from 50% to 60%. *Supra* text accompanying note 77. If the court orders the "'guilty' stockholder" to pay the corporation $2.5 million, then the minority shareholders will be restored to their former economic position—40% × $12.5 million = 50% × $10 million—even though the guilty stockholder "benefited" from the payment to the corporation; there is, of course, no actual benefit to the guilty stockholder from this payment.

103 *Cf.* Am. L. Inst., *supra* note 52, § 7.01(d) (recommending that courts treat derivative claims as direct when, inter alia, an individual recovery "will not . . . interfere with a fair distribution of the recovery among all interested persons").

104 *See, e.g.*, Diamond State Brewery v. De La Rigaudiere, 17 A.2d 313, 317 (Del. Ch. 1941). In cases in which the controller paid some amount for the shares but not full market value, the court can order that some, but not all, of the wrongfully issued shares be canceled such that the controller receives a number of shares equal to what they would have fairly received for the consideration paid.

105 *See* Grimes v. Donald, 673 A.2d 1207, 1213 (Del. 1996), *overruled in part by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

Even in many classically direct claims, one can imagine corporate recoveries that are nevertheless fair and equitable. For example, suppose a controller causes a cash dividend to be paid to itself but not to minority shareholders holding the same class of stock. The minority shareholders then sue. It would be an equitable remedy to order the corporation to pay the dividend to the minority, suggesting that the claim is direct. But another equitable remedy might be to order the controller to repay the cash dividend to the corporation, suggesting that the claim is derivative.

And, of course, it would not do to simply say that *Tooley*'s second prong depends on the remedy requested by the shareholder. First, this would invite endless pleading games on the part of plaintiffs. It is for good reason that the direct or derivative character of a claim does not depend on the flourishes with which a plaintiff pleads that claim.[106] This is particularly true in shareholder litigation, which, like all representative litigation, often affects the rights of absent parties.[107] Second, as illustrated above, many derivative claims can be equitably resolved by ordering that a recovery go directly to a corporation's shareholders.[108] There consequently would be no real limit to a plaintiff's ability to demand direct shareholder remedies and plead direct claims, neutering the discriminatory power of a test that naively asks who would receive the benefit of the court's remedy.

2. *The Impact of the Chosen Remedy*

The choice of remedy affects who nominally receives the remedy, but, even after having decided upon a particular remedy, its impact is often hard to determine. Many remedies that target shareholders also have significant beneficial impact upon the corporation. In turn, beneficial impact is often multifaceted in ways that do not always neatly conform to *Tooley*'s distinction between direct and derivative suits.

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106 Dieterich v. Harrer, 857 A.2d 1017, 1027 (Del. Ch. 2004); *In re* Syncor Int'l Corp. S'holders Litig., 857 A.2d 994, 997 (Del. Ch. 2004).

107 *See, e.g.*, QVC Network v. Paramount Commc'ns Inc., 653 A.2d 1245, 1272 n.49 (Del. Ch. 1993).

108 *Supra* text accompanying notes 104–05. Similarly, suggestions that a direct claim should be found to exist if "the injured shareholders other than the plaintiff will share in the recovery . . . *only if the action is a class action* brought on behalf of all these shareholders" make little sense. Am. L. Inst., *supra* note 52, § 7.01 cmt. d (emphasis added). For example, to the extent that a court would have granted the sought-after relief in *Grimes*—that the chief executive officer's employment contract was invalid—the effects of such relief would have fallen upon all shareholders regardless of whether the case was brought as a class action. *See Grimes*, 673 A.2d at 1210. Likewise, a claim seeking equitable relief for shares that were issued ultra vires is generally agreed upon to be direct, Eastland Food Corp. v. Mekhaya, 301 A.3d 308, 357 n.11 (Md. 2023); Schuster v. Gardner, 25 Cal. Rptr. 3d 468, 474 (Cal. Ct. App. 2005); 12B William Meade Fletcher, Fletcher Cyclopedia of the Law of Corporations § 5915.10 (rev. 1984), though a remedy that cancels the wrongfully issued shares would benefit all other shareholders regardless of class action status.

For example, in a proceeding to determine the outcome of a disputed board election, who benefits from the remedy?[109] Although courts treat such claims as direct,[110] it seems bizarre that a corporation receives no benefit from a court correctly determining who its rightful directors are. In fact, courts have expressly stated that corporations benefit from such proceedings,[111] suggesting under *Tooley*'s second prong that the claim should be derivative.[112] Yet the courts' treatment of such claims as direct also just makes good sense, even aside from any statutory approbations, as it would be no less bizarre to state that a suit to determine the outcome of a board election should ordinarily be under the control of the board—the identity of whom is the very subject in controversy.

Likewise, plaintiffs have pressed direct claims challenging severance provisions of chief executive officer ("CEO") employment contracts[113] and loan agreements from corporate insiders.[114] In *Grimes v. Donald*,[115] the shareholder sought, inter alia, to relieve the corporation of its contractual obligation to pay millions of dollars if the CEO were to be fired, and the court held that the claim was direct.[116] The court agreed with the plaintiffs' characterizations of such claims as direct in part because the relief demanded—recission of the contracts or the relevant terms—was prospective in nature and did not necessarily impact the corporation monetarily.[117] But is it credible that recissions of such contracts would not affect the corporation simply because there would be no cash payout to the corporation?[118]

As a contrast to *Grimes*, consider a hypothetical in which a shareholder seeks to relieve a corporation of its contingent obligations under an insurance contract to reimburse a policyholder for certain potential

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109 *See* Del. Code Ann. tit. 8, § 225 (2024).

110 *See, e.g.*, Insituform of N. Am., Inc. v. Chandler, 534 A.2d 257, 270 n.11 (Del. Ch. 1987). *See generally* Donald J. Wolfe Jr. & Michael A. Pittenger, Corporate and Commercial Practice in the Delaware Court of Chancery § 9.09(c) (2d ed. 2019).

111 Agranoff v. Miller, 734 A.2d 1066, 1072 (Del. Ch. 1999) ("[T]he § 225 remedy should exist . . . for the benefit of the corporation . . . .").

112 *Cf.* San Antonio Fire & Police Pension Fund v. Bradbury, No. 4446-VCN, 2010 WL 4273171, at *9 (Del. Ch. Oct. 28, 2010).

113 *See, e.g.*, Grimes v. Donald, 673 A.2d 1207, 1211, 1213 (Del. 1996), *overruled in part by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000); *see also supra* note 108; *cf.* Chrystall v. Serden Techs., 913 F. Supp. 2d 1341, 1347, 1361 (S.D. Fla. 2012).

114 *See, e.g.*, Grayson v. Imagination Station, Inc., No. 5051-CC, 2010 WL 3221951, at *4–6 (Del. Ch. Aug. 16, 2010).

115 673 A.2d 1207 (Del. 1996), *overruled in part by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

116 *Id.* at 1210, 1213.

117 *Id.* at 1213; *see also Grayson*, 2010 WL 3221951, at *6.

118 *Cf.* San Antonio Fire & Police Pension Fund v. Bradbury, No. 4446-VCN, 2010 WL 4273171, at *9, 11 (Del. Ch. Oct. 28, 2010) (finding that plaintiffs had been entitled to file a direct claim challenging the propriety of entering into agreements that made it difficult to elect new directors and that corporate benefit resulted from litigation that caused the corporation to obtain waivers of relevant provisions and approvals of shareholder board nominees).

losses. In such a case, the benefit from avoiding the contract clearly accrues to the corporation.[119] And, of course, there are obvious policy reasons for a claim seeking avoidance of an insurance contract to be under the control of the board of directors and subject to demand futility should a shareholder seek to assert it derivatively. All said, what about *Grimes*'s recission remedy results in the corporation receiving qualitatively fewer benefits than in the insurance contract case?

C. *The Internal Inconsistency of* Tooley

Besides the flaws in *Tooley*'s overall structure, its application by the Delaware courts has been internally awkward. This is because even if we conceptually accept *Tooley*'s focus on the corporate balance sheet to determine whether the corporation was injured,[120] numerous cases that have found corporate harm—and consequently, that a claim must be pursued derivatively—simply involved no harm to the value of the corporate entity.[121] That said, note that these inconsistencies are likely the result of well-intentioned attempts to limit other negative consequences of *Tooley*, and that inconsistencies illustrated in this Section are but one expression of *Tooley*'s structural faults.

This issue appears to arise in significant part from some semantic confusion. Understandably, the Delaware courts have defined "overpayment" to mean where a corporation has given over something of greater value in exchange for something of lesser value.[122] But for unclear reasons, the Delaware courts have also long used the terms "dilution" and "overpayment" interchangeably to refer to cases in which shareholders have suffered an economic harm due to an unbalanced transaction.[123] In accordance with that interchangeability, Delaware courts—contrary

119 To the extent that courts have characterized some claims as "dual-natured" rather than applying an exclusive dichotomy between direct and derivative claims, *see, e.g.*, *In re* El Paso Pipeline Partners, L.P. Derivative Litig., 132 A.3d 67, 82 (Del. Ch. 2015), *rev'd sub nom.* El Paso Pipeline GP Co. v. Brinckerhoff, 152 A.3d 1248 (Del. 2016). That does not affect the ultimate issue, which is really whether a direct claim is available, as the direct claim will generally give the plaintiff the most access to the courtroom. *Supra* notes 3–8 and accompanying text. Regardless of its pure analytical merits, a rework of *Tooley* that merely designates all claims as dual-natured will have failed to address the policy issues at stake in this example.

120 *See* Brookfield Asset Mgmt., Inc. v. Rosson, 261 A.3d 1251, 1266 (Del. 2021) (dilution arises from "reduction in the value of the entire corporate entity").

121 *See, e.g.*, *In re* Gaylord Container Corp. S'holders Litig., 747 A.2d 71, 80 (Del. Ch. 1999).

122 *See* Gentile v. Rossette, 906 A.2d 91, 99 (Del. 2006). Given this definition of overpayment, it is syllogistic that all properly pled cases of overpayment are wrongful. With that said, unlike "dilution," "overpayment" is not a term of art within the economic and finance world, and this definition of "overpayment" does not conflict with other usages.

123 *See supra* note 64; *see also Brookfield*, 261 A.3d at 1275 (calling the "expropriation of economic value" in *El Paso* an "economic dilution"); *Gentile*, 906 A.2d at 99 (positing that a "dilution" in value may occur as a result of overpayment with corporate cash); *El Paso*, 152 A.3d at 1251, 1262 (suggesting that an overpayment claim constituted "dilution").

to common usage anywhere else—apply the term "dilution" to cases in which a corporation's stock is economically devalued without any concomitant reduction in the existing equity holders' proportional ownership share of the firm.

Yet the term "dilution" has a well-established meaning that differs from the Delaware courts' usage and only partially overlaps with any plausible interpretation of "overpayment." In fact, outside of the Delaware courts, "dilution" is generally accepted to mean a decrease in existing equity holders' ownership share of a corporation's equity from the issuance of new equity.[124] Under such a usage, all stock issuances after the moment of incorporation invariably "dilute" the proportionate economic and voting interests represented by existing stock.[125] However, under this definition of dilution, not all dilutions are wrongful, or else no corporation would ever be able to rightfully conduct a secondary offering.[126]

Accordingly, in contrast with the Delaware courts' usage, the commonly accepted definition of "dilution" does not necessarily imply overpayment or vice versa. For example, a corporation whose stock has been trading for $50 per share and then issues new stock for $50 per share has undergone a dilutive offering, though there is no plausible claim of overpayment or economic harm to shareholders.[127] Indeed, a dilution should only be actionable if it was somehow unfair to existing shareholders, as might be the case if the new shares are issued in exchange for consideration below the fair value of existing shares. Conversely, a corporation that pays $1 million for a $1 asset has overpaid for that asset,[128] but it has not "diluted" the corporation's shares, at least not within the commonplace use of the term "dilute." In other words, with their usage of "dilution," the Delaware courts have gone against the traditional and generally accepted usage of the term and conflated several different concepts.[129]

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124 *See, e.g.*, *Equity dilution*, A Dictionary of Accounting (5th ed. 2016); Peter Moles & Nicholas Terry, The Handbook of International Financial Terms 189 (1997). Within the commonplace use of the term "dilution," shareholders are diluted whenever their percentage ownership of the corporation's equity decreases and does not depend on whether their proportional stake decreases in economic value. *See Equity dilution, supra.*

125 *See Understanding Equity Dilution*, Morgan Stanley at Work (Nov. 25, 2024), https://www.morganstanley.com/atwork/articles/what-is-equity-dilution [https://perma.cc/5W7N-QS9S].

126 *See* Julia Kagan, *What Is a Secondary Offering? How They Work, Types, and Effects*, Investopedia (May 28, 2022), https://www.investopedia.com/terms/s/secondaryoffering.asp [https://perma.cc/6NNJ-WDL9].

127 Because the corporation's assets have grown, the existing shareholders' shares have the same economic value before and after the offering.

128 The same would be true if the corporation sells a $1 million asset for $1.

129 *See supra* text accompanying note 81; El Paso Pipeline GP Co. v. Brinckerhoff, 152 A.3d 1248, 1251, 1262 (Del. 2016).

Moreover, to the extent that a dilutive offering entails any negative effects, such effects fall solely upon previous shareholders. This is because when a corporation undergoes a stock offering, the corporation's net assets and total equity value do not shrink—instead, they either grow (in cases in which the corporation received something in exchange for the new stock) or, at worst, stay constant (in cases in which the corporation received nothing in exchange for the new stock).[130] Therefore, in cases of dilution, there is no valid derivative claim, as the corporation suffered no harm or injury through which shareholders could be derivatively harmed.[131] Instead, properly analyzed under the lens of corporate harm, all claims relating to such dilutions can only be direct claims.

A sample balance sheet serves to illustrate the matter. In this example, the corporation originally has 100 shares of stock, as shown in Figure 1, and issues 1,000 additional shares for $10 each, as shown in Figure 2:[132]

FIGURE 1. PREDILUTION

Assets		**Liabilities**	
Cash	$100,000	Debt	$100,000
Inventory	$100,000	Total liabilities	$100,000
Equipment	$0		
Total assets	$200,000	**Shareholders' equity**	$100,000
Number of shares: 100	Value per share: $1,000		

FIGURE 2. POSTDILUTION

Assets		**Liabilities**	
Cash	$110,000	Debt	$100,000
Inventory	$100,000	Total liabilities	$100,000
Equipment	$0		
Total assets	$210,000	**Shareholders' equity**	$110,000
Number of shares: 1,100	Value per share: $100		

130 Accordingly, the suggestion in *Brookfield* that a "reduction in the value of the entire corporate entity . . . is a typical result of a corporation's raising funds through the issuance of additional new shares" is incorrect. Brookfield Asset Mgmt. v. Rosson, 261 A.3d 1251, 1266 (Del. 2021). More funds, of course, leads to greater corporate entity values even if the per share value is less after the funds are raised.

131 It does not suffice to respond that the corporation suffered a harm simply because the corporation could have raised more money had the issuance been at a higher price. Among other things, an analogous case could be made that the corporation did not suffer a harm because the issuance could have been for fewer shares in exchange for the same amount of total funds.

132 Assume that the issuance is not pro rata to the existing shareholders' holdings.

As can be seen, contrary to *Brookfield*, there was no "reduction in the value of the entire corporate entity"[133] as a result of the stock offering; the corporation's assets and net assets have increased and the total shareholders' equity has increased.[134] The only potential harm or injury from the offering falls on previous shareholders, whose shares have decreased in value from $1,000 per share to $100 per share due to their lower proportionate ownership of the corporation.[135] In *Brookfield* itself, the transaction at issue resulted in $650 million more in corporate net assets.[136] *Brookfield* does not—and cannot—explain how obtaining $650 million in *net* assets injured the corporation. Instead, the claim in *Brookfield* should have been treated as a direct claim because the harm was solely to the complaining shareholders. Nevertheless, *Brookfield* treats claims arising out of transactions like these as derivative because such transactions supposedly "deprive[] the corporation of assets."[137]

Furthermore, the word "overpayment" can be misleading in so-called "stock overpayment" cases such as the example above. According to the Delaware courts, in stock overpayment cases, corporate harm supposedly derives from exchanging high-value treasury stock for a low-value asset.[138] However, this conception is flawed because unissued treasury stock has no value at all from a corporate balance sheet perspective and is not an asset of the corporation in any meaningful economic sense.[139] Otherwise, a corporation could increase its value—

133 *Brookfield*, 261 A.3d at 1266.

134 This example can be extended to purportedly unfair de-SPAC transactions, in which a Special Purpose Acquisition Vehicle ("SPAC") merges with a purportedly overvalued target, as follows. *See, e.g.*, Delman v. GigAcquisitions3, LLC, 288 A.3d 692, 708 (Del. Ch. 2023). In a de-SPAC transaction, the SPAC issues stock in exchange for the target's stock, which by assumption is worth less per share than the SPAC's pre-de-SPAC shares. *See* Randy Schwartzman & Eric Mauner, *Important Tax Issues When Navigating a SPAC Transaction*, BDO USA (Aug. 23, 2021), https://www.bdo.com/insights/tax/important-tax-issues-when-navigating-a-spac-transaction [https://perma.cc/RA35-KGWE]. In such an event, the result is the same: the SPAC's original shareholders are left with stock that is worth less per share than what they started with, even though the post-merger entity has a greater total equity value.

135 Note that if any reduction in the value per share could be considered a harm to the corporation, then a simple stock split could be a corporate harm, as would any dilutive offering nullified by an offsetting reverse stock split. Clearly, it is the aggregate equity value of the corporation that is of interest to the corporate harm analysis, not the mechanics of how that value has been split into shares.

136 *Brookfield*, 261 A.3d at 1258.

137 *Id.* at 1277.

138 *See, e.g.*, Gentile v. Rossette, 906 A.2d 91, 100 (Del. 2006) ("Because the means used to achieve that result is an overpayment (or 'over-issuance') of shares to the controlling stockholder, the corporation is harmed and has a claim to compel the restoration of the value of the overpayment."); Karasik v. Pac. E. Corp., 180 A. 604, 606 (Del. Ch. 1935).

139 Vice Chancellor Laster has made this point in several opinions but was rebuffed by the Delaware Supreme Court at each turn. New Enter. Assocs. 14, L.P. v. Rich, 292 A.3d 112, 156 & n.26 (Del. Ch. 2023).

and increase its existing shareholders' wealth—simply by creating more unissued shares. To the extent that an equity issuance ever constitutes overpayment, it is not the corporation's assets that are offered as the overpayment but rather those of the existing shareholders.[140] But, absent a corporate harm, there is little rationale for drawing derivative claims from such fact patterns.

Finally, the Delaware courts' handcuffing of "dilution" with "overpayment" implies that all instances of "dilution" are necessarily wrongful—as "overpayment" is wrongful by definition—even though the traditional usage of "dilution" does not necessarily imply wrongfulness.[141] This is because the Delaware courts correctly recognize that voting and economic dilution go hand-in-hand,[142] and once a plaintiff has alleged that they have lost voting power as a result of a dilutive transaction, they have consequently also alleged economic dilution. Thus, because the Delaware courts treat economic dilution and overpayment as synonymous, it follows under the Delaware courts' logic that any loss in voting power is necessarily connected to some wrongful overpayment, which, as explained above, is not the actual case.[143]

In order to limit the crush of meritless claims, Delaware has chosen to treat all of these cases as derivative claims.[144] It is this logic that should caution us against mistaking these inconsistencies for simple errors that can be fixed without collateral consequences. Rather, these flaws are a part of an imperfect stopgap for a deeply flawed framework. And imperfect it is: the categorization of all so-called "dilution-overpayment" claims as derivative claims and the placement of additional burdens on such claims—not the least being the continuous ownership requirement[145]—has limited plaintiffs' access to judicial redress even when the claim is fundamentally meritorious.

D. A Note on Exceptions for Close Corporations

Following guidelines promulgated by the American Law Institute ("ALI"), some jurisdictions outside of Delaware have adopted an approach whereby a *Tooley*-like analysis is applied to most shareholder claims but with an exception for claims involving closely held

140 *See* 1 SEYMOUR D. THOMPSON, COMMENTARIES ON THE LAW OF PRIVATE CORPORATIONS § 1061 (1895).

141 *Supra* notes 122–26 and accompanying text.

142 *See Brookfield*, 261 A.3d at 1266; *see also Gentile*, 906 A.2d at 100.

143 This was essentially the problem the court faced in *Feldman v. Cutaia*, 951 A.2d 727, 729–32 (Del. 2008), which is discussed in further detail, *supra* note 64.

144 *See Brookfield*, 261 A.3d at 1277.

145 *Id.* at 1262 n.35.

corporations,[146] defined as "corporation[s] the equity securities of which are owned by a small number of persons, and for which securities no active trading market exists."[147] Under that exception, "the court in its discretion may treat an action raising derivative claims as a direct action" if doing so would satisfy certain fairness conditions, such as a lack of prejudice toward creditors.[148]

This Article, however, rejects such an approach. First, whenever the claim relates to a widely held corporation, all the problems discussed in the rest of this Section still remain. Second, several of the reasons given for the closely held corporation exception also apply to widely held corporations with a controller. For example, the Indiana Supreme Court has argued that a direct claim is appropriate in closely held corporations because "shareholders in a close corporation stand in a fiduciary relationship to each other."[149] Yet a controller also owes fiduciary duties to minority shareholders, even when there is a multiplicity of minority shareholders.[150]

Likewise, in *Durham v. Durham*,[151] the New Hampshire Supreme Court recognized the "burdensome, and often futile, procedural requirements when a minority shareholder seeks to redress wrongful behavior by the majority shareholders."[152] Of course, the same reasoning should apply to widely held companies with a controller.

Furthermore, the suggested fairness conditions can often be satisfied with widely held corporations. For instance, the requirement that claims qualifying for direct treatment not "materially prejudice the interests of creditors of the corporation"[153] will generally be satisfied whenever the corporation is not teetering on bankruptcy, regardless of the shareholding structure of the corporation.[154]

Conversely, the policy reasons motivating the exception for closely held corporations often do not even apply to many closely held corporations. For instance, recall the argument in *Durham* about the futility of procedural requirements when fighting a controller.[155] But, as defined,

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146 Am. L. Inst., *supra* note 52; *see, e.g.*, Trieweiler v. Sears, 689 N.W.2d 807, 837–38 (Neb. 2004); Barth v. Barth, 659 N.E.2d 559, 561–62 (Ind. 1995); Aurora Credit Servs., Inc. v. Liberty W. Dev., Inc., 970 P.2d 1273, 1280–81 (Utah 1998); Schumacher v. Schumacher, 469 N.W.2d 793, 798–99 (N.D. 1991).

147 Am. L. Inst., *supra* note 52, § 1.06 (citation omitted).

148 *Id.* § 7.01(d).

149 *Barth*, 659 N.E.2d at 561.

150 Delman v. GigAcquisitions3, LLC, 288 A.3d 692, 712 (Del. Ch. 2023).

151 871 A.2d 41 (N.H. 2005).

152 *Id.* at 46.

153 Am. L. Inst., *supra* note 52, § 7.01(d); *see also Barth*, 659 N.E.2d at 562.

154 *See* Am. L. Inst., *supra* note 52, § 7.01 cmt. e ("[W]hen a direct action is brought on behalf of the entire class of injured shareholders and the corporation's solvency is not in question, there is less reason to insist that the action be brought derivatively.").

155 *Durham*, 871 A.2d at 46.

closely held corporations need not have a majority or otherwise controlling shareholder.[156] And, of course, in many small startups, there remains good reason to contain shareholder suits so as to ensure that disgruntled employees who received equity compensation cannot hamstring the corporation with undue litigation, even if the total number of shareholders remains low.[157] In these cases, the burdens of derivative litigation remain appropriate.

Now, this is not to say that in many instances involving closely held corporations, "[t]he derivative/direct distinction makes little sense when the only interested parties are two individuals or sets of shareholders."[158] But, as illustrated here, and discussed further below, the crux of the matter is not and should not be whether the corporation is closely held but whether a shareholder inequitably used their control rights to effect the harm at issue.

III. The Quagmire of Legal History

In reaching their conclusions, *Tooley*, *Brookfield*, and other judicial opinions concerning the direct-derivative distinction rely heavily on the history of that distinction and of shareholder suits in general.[159] Indeed, the Delaware courts have been grappling with how to distinguish a derivative from a direct claim for nearly 100 years. Unfortunately, despite good intentions aimed at solving the practical issues posed by the direct-derivative distinction, the courts have yet to complete a logically solid doctrinal foundation. Instead, the caselaw has often been built upon flawed interpretations of previous—and also often flawed—caselaw. Even the opinions that elucidate matters and move understanding forward are often forgotten and their legal effect undone by subsequent cases.

Despite flaws and inconsistencies in the caselaw, *Tooley* and *Brookfield* rely heavily on precedent in their judicial reasoning and often infer threads and lessons that are not really present. Accordingly, a comprehensive response to *Tooley* is incomplete without a reevaluation of the history of the shareholder suit and the direct-derivative distinction,[160] a reevaluation that shows that the main lesson to be learned from the caselaw is that it contained a lot of confusion, contradiction, and

156 *See* Am. L. Inst., *supra* note 52, § 1.06. Suits often arise to resolve deadlocks in close corporations in which no shareholder has a controlling majority. *See Deadlock in a Close Corporation: A Suggestion for Protecting a Dissident, Co-Equal Shareholder*, 1972 Duke L.J. 653, 654–55.

157 *See* Am. L. Inst., *supra* note 52, § 7.01 cmt. d.

158 2 Robert B. Thompson, O'Neal and Thompson's Close Corporations and LLCs § 9:22 (rev. 3d ed. 2011), *quoted in Durham*, 871 A.2d at 46.

159 *See supra* Section I.A.

160 Although this Part is primarily focused on Delaware legal history, jurists and practitioners from other jurisdictions should likely be able to adapt the broad lessons of this Part to the caselaw of their jurisdiction, given the widespread complaints of complexity and misunderstanding regarding the direct-derivative distinction.

amnesia. Frankly, casual readers are cautioned that this history will not likely improve their understanding of the underlying substance of the direct-derivative distinction, and they may wish to simply skip to the next Part.

*A. The Pre-*Tooley *Caselaw*

As noted above, the oldest derivative claims were a varied bunch, encompassing claims in which a shareholder alleged management misconduct as well as claims against third parties at arm's length with the corporation.[161] By contrast, claims involving plain self-dealing in the company's shares were often treated as direct claims.[162] As such, statements from recent Delaware decisions that claims where "the entity got too little value in exchange for shares" constitute "the most traditional type of derivative claim"[163] are unsupported: stock overpayment claims are not "the most traditional type of derivative claim," and similar claims were often treated as direct claims.[164] In fact, the early case of *Witherbee v. Bowles*[165] expressly considered whether a stock overpayment claim should be treated as derivative or direct and concluded that such claims were exclusively direct, or "individual," in the parlance of the *Witherbee* court.[166]

With that said, difficulties in determining whether a claim should be treated as direct or derivative quickly arose, given how corporate misconduct may take different nominal forms with identical economic impacts, as discussed above.[167] The Delaware courts first waded into the direct-derivative bog in *Eshleman v. Keenan*,[168] in which a party tried to recharacterize a derivative claim as a direct claim.[169] The plaintiff alleged that the directors wrongfully caused the corporation to pay management fees to its majority shareholder.[170] In a reversal from the usual course of events, the defendants attempted to characterize the claim as direct rather than derivative.[171] They argued that although they

161 *Supra* notes 29–37 and accompanying text.

162 *See supra* notes 26–28 and accompanying text.

163 El Paso Pipeline GP Co. v. Brinckerhoff, 152 A.3d 1248, 1266 (Del. 2016) (Strine, C.J., concurring). Unfortunately, subsequent cases such as *Brookfield* have adopted this reasoning. *See* Brookfield Asset Mgmt., Inc. v. Rosson, 261 A.3d 1251, 1266 (Del. 2021); Sciabacucchi v. Liberty Broadband Corp., No. 11418-VCG, 2018 WL 3599997, at *8 (Del. Ch. July 26, 2018).

164 *See supra* note 27 and accompanying text.

165 95 N.E. 27 (N.Y. 1911).

166 *Id.* at 28–29.

167 *Supra* text accompanying note 71.

168 187 A. 25 (Del. Ch. 1936).

169 *Id.* at 26–27.

170 *Id.* at 26.

171 Eshleman v. Keenan, 194 A. 40, 42 (Del. Ch. 1937). Usually, it is plaintiffs who attempt to characterize a claim as direct, as direct claims are not subject to the various hurdles that impede

were liable for causing the corporation to pay wrongful management fees, they only had to reimburse the complaining shareholders their pro rata share rather than reimburse the corporation in full.[172] The Court of Chancery rejected that argument, noting that a direct claim for mismanagement would not have been available because claims for mismanagement formally belong to the corporation and must be pleaded as derivative claims.[173] Of course, as explained earlier, instead of receiving management fees in the form of a salary, the controller could have received his fees as dividends accruing to his shares alone,[174] an arrangement that would seemingly prompt treatment of any ensuing claim as a direct claim under existing frameworks.[175]

After *Eshleman*, years passed before the Court of Chancery issued *Bennett v. Breuil Petroleum Corp.*,[176] which held that a dilution claim is a direct claim, at least where the purpose of the dilutive offering was improper, such as to freeze out a minority.[177] Note that *Bennett*'s existence thus undermines *Brookfield*'s assertion that there is a "general rule that equity dilution claims are solely derivative."[178] *Bennett* further ruled that a direct claim for dilution may lie even where the plaintiff has an opportunity to participate in the dilutive offering pro rata to his existing holdings, at least if the offering price is inadequate.[179] Unfortunately, this aspect of *Bennett* would be frequently forgotten or ignored in the following decades.[180] On the other hand, *Bennett* held that, insofar as the consideration actually paid for the dilutive shares was allegedly below the fair value of existing shares, the corporation was injured and the ensuing claim was accordingly derivative.[181] As discussed above, it makes little sense to treat overpayment for stock as a corporate harm or injury.[182]

Just two months after the Court of Chancery decided *Bennett*, the Court first used the much-maligned term "special injury" to characterize direct claims in *Elster v. American Airlines*.[183] However, *Elster* never defined "special injury,"[184] and the term would go on to confuse and

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derivative claims. *Supra* notes 3–8 and accompanying text.

172 *See Eshleman*, 194 A. at 42.

173 *Id.* at 43.

174 *See supra* note 92 and accompanying text.

175 *See, e.g.*, Notz v. Everett Smith Grp., Ltd., 764 N.W.2d. 904 (Wis. 2009).

176 99 A.2d 236 (Del. Ch. 1953).

177 *Id.* at 240–41.

178 Brookfield Asset Mgmt., Inc. v. Rosson, 261 A.3d 1251, 1275 (Del. 2021).

179 *Bennett*, 99 A.2d at 240–41.

180 *See, e.g.*, *Brookfield*, 261 A.3d at 1266.

181 *See Bennett*, 99 A.2d at 241.

182 *Supra* Section II.A.1.

183 Elster v. Am. Airlines Inc., 100 A.2d 219, 222 (Del. Ch. 1953).

184 *Id.*

annoy jurists for decades.[185] The claim in *Elster* concerned stock options that American Airlines had previously granted to certain executives, which a shareholder claimed constituted waste.[186] The Court of Chancery held that the claim was derivative, reasoning as follows:

> The injuries of which plaintiff complains, unless we except plaintiff's claim as to the dilution of his stock, consist entirely of injuries to the corporation and its stockholders as a class. Any injury which plaintiff may receive by reason of the dilution of his stock would be equally applicable to all the stockholders of defendant, since plaintiff holds such a small amount of stock in proportion to the amount of stock outstanding that the control or management of defendant would not be affected by the granting of these options, and, further, since there is no averment that the pre-emptive rights of plaintiff as a stockholder are affected by their issuance. . . . There are cases, of course, in which there is injury to the corporation and *also special injury to the individual stockholder*. In such case a stockholder, if he should so desire, may proceed on his claim for the protection of his individual rights rather than in the right of the corporation. The action would then not constitute a derivative action.[187]

Much of the foregoing is problematic, a fact that *Tooley* and *Brookfield* correctly recognized. First, as mentioned, *Elster* never clearly defined what exactly constituted a "special injury," at most suggesting that injuries to preemptive rights or control rights *might* constitute a special injury.[188] Second, *Elster*'s treatment of shareholder rights is a non sequitur: even if it were true that the plaintiff suffered no injury different from that of other shareholders, it does not follow that such a claim should be derivative.[189] Relatedly, though the court singled out the lack of injury to the plaintiffs' preemptive rights, it is still unclear under the court's logic whether such an injury would constitute a "special injury" if other shareholders' preemptive rights were also injured.[190] Finally, *Elster* strangely suggested that even voting rights infringement might not constitute a special injury, especially if the plaintiff owns but a small minority stake.[191]

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185 *See* Tooley v. Donaldson, Lufkin, & Jenrette, Inc., 845 A.2d 1031, 1037–38 (Del. 2004).

186 Actually, two shareholders, but, as one was dismissed for other reasons, only one of them is relevant to the discussion. *See Elster*, 100 A.2d at 221, 225.

187 *Id.* at 222 (emphasis added).

188 *See Tooley*, 845 A.2d at 1037.

189 *Id.*

190 *See* Brookfield Asset Mgmt., Inc. v. Rosson, 261 A.3d 1251, 1269, 1273 (Del. 2021).

191 *See Elster*, 100 A.2d at 222. This questionable line of reasoning—that the direct or derivative character of a claim depends on the degree to which the plaintiff was injured—foreshadows

Following the confusion strewn about in *Elster*, the next several decades of Delaware law represented an uneven effort to pick up the pieces. In *Bokat v. Getty Oil Co.*,[192] the Delaware Supreme Court never cited to *Elster* or used the term "special injury," but it nonetheless accorded with *Elster*'s problematic reasoning and held that "[w]hen an injury to corporate stock falls equally upon all stockholders, then an individual stockholder may not recover for the injury to his stock alone, but must seek recovery derivatively in behalf of the corporation."[193] As explained above, there is no necessary logical connection between the direct or derivative nature of an action and the proportion of shareholders affected by the alleged harm,[194] and *Tooley* correctly identified *Bokat*'s holding as a "confusing and inaccurate" statement.[195]

Like *Elster*, the Court of Chancery decision in *Moran v. Household International, Inc.*[196] also denigrated harms to shareholder voting rights.[197] *Moran* is remembered today primarily for its holding regarding a poison pill that purportedly limited shareholders' ability to engage in a proxy contest.[198] But before reaching the substance of its analysis of poison pills, *Moran* first considered whether challenges concerning the propriety of poison pills generally should be deemed direct or derivative, incorrectly concluding that the challenge was derivative.[199]

The error in *Moran* was not so much in the rule statement, which evidently sought to build upon the special injury test, even as it avoided that particular term[200]:

> 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.[201]

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the reasoning used in *Moran* and *Brookfield*. *See* Moran v. Household Int'l, Inc., 490 A.2d 1059, 1070 (Del. Ch. 1985), *aff'd*, 500 A.2d 1346 (Del. 1985); *Brookfield*, 261 A.3d at 1275.

192 262 A.2d 246 (Del. 1970).

193 *See id.* at 249.

194 *See* text accompanying note 189.

195 Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1037 (Del. 2004).

196 490 A.2d 1059 (Del. Ch. 1985).

197 *See id.* at 1079–80.

198 *See id.*

199 *See id.* at 1070.

200 *See* Lipton v. News Int'l, 514 A.2d 1075, 1078 (Del. 1986). In formally adopting the "special injury" test, *Lipton* noted that it understood that the *Moran* formulation was merely a restatement of the special injury test. *Id.*

201 *Moran*, 490 A.2d at 1070 (footnote omitted) (citations omitted) (quoting 12B William Meade Fletcher, Fletcher Cyclopedia of the Law of Corporations § 5921 (rev. 1984)) (citing Bokat v. Getty Oil Co., 262 A.2d 246, 249 (Del. 1970)).

Although *Moran* does not trace the origin of the term "separate and distinct," it appears to have first arisen in a 1965 Florida case. *See* Citizens Nat'l Bank of St. Petersburg v. Peters, 175 So.

The problem with *Moran* was that, notwithstanding its inclusion of the "contractual right" prong in its rule statement, the court then gutted that same prong in its analysis.[202] Despite finding a fair allegation that the defendants had "restrict[ed] the shareholders' right to make use of the [corporation's] proxy machinery," *Moran* somehow concluded that there was no direct harm because:

> [N]o shareholder is presently engaged in a proxy battle, and the alleged manipulation of corporate machinery does not directly prohibit proxy contests . . . . Thus, although the [poison pill]'s impact on proxy contests may ultimately alter the balance of power between shareholders and the board of directors, this allegation does not involve a contractual right of the shareholders.[203]

Subsequent cases repudiated such logic. For example, *Lipton v. News International*[204] held that "[t]he right to vote is a contractual right that [a shareholder] possesses[,] . . . which is independent of any right of [the corporation]."[205]

In 1988's *Kramer v. Western Pacific Industries*, the Delaware Supreme Court used the special injury test to determine that a claim regarding a merger and golden parachutes that were offered to executives shortly before that merger was derivative.[206] Notably, the pleadings—and outcome—in *Kramer* were clearly influenced by the then-recent *Lewis v. Anderson* decision.[207] In *Lewis*, the Delaware Supreme Court held that improperly granted golden parachutes do not reduce a corporation's net worth or sale price because a rational buyer of the corporation would include in their offer price the value of any legitimate claims, including the value of any breach of fiduciary duty

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2d 54, 56 (Fla. Dist. Ct. App. 1965).

The court's use of the word "contractual" refers to all the rights of shareholders that arise under a corporation's charter, bylaws, and the state law of corporations. *See* Boilermakers Loc. 154 Ret. Fund v. Chevron Corp., 73 A.3d 934, 940 (Del. Ch. 2013); *see also* STAAR Surgical Co. v. Waggoner, 588 A.2d 1130, 1136 (Del. 1991); Del. Code Ann. tit. 8, § 394 (2024) ("This chapter and all amendments thereof shall be a part of the charter or certificate of incorporation of every corporation . . . ."); Stephen M. Bainbridge, Unocal *at 20: Director Primacy in Corporate Takeovers*, 31 Del. J. Corp. L. 769, 777–81, 813–14 (2006).

202 *Moran*, 490 A.2d at 1070.

203 *Id.*

204 514 A.2d 1075 (Del. 1986).

205 *Id.* at 1079; *see also In re* Gaylord Container Corp. S'holders Litig., 747 A.2d 71, 79 (Del. Ch. 1999) ("[I]f it is alleged that the directors reduced the voting power of stockholders through inequitable action, that suffices to state a direct claim . . . .").

206 Kramer v. W. Pac. Indus., Inc., 546 A.2d 348, 352 (Del. 1988).

207 *Id.* at 349.

claims against the directors who granted the golden parachutes.[208] Following such reasoning, the *Kramer* plaintiff was in the awkward position of arguing that shareholders had been "wrongfully deprived" of merger proceeds even though he "d[id] not dispute the adequacy of the tender offer/merger price," as doing so would have required him to dispute *Lewis*'s holding.[209] Accordingly, *Kramer* held that "[t]he amended complaint may not be reasonably construed as alleging a 'special injury'" because the allegedly improper golden parachutes did not affect the ratability of the sale proceeds.[210] Still, *Kramer* continued to hold that former shareholders attacking the price of a merger could plead a direct claim.[211]

Notably, *Kramer*'s articulation of the distinction between direct and derivative claims would be later praised and used as the inspiration for the modern test.[212] As *Kramer* expressed, "[w]hether a cause of action is individual or derivative must be determined from the 'nature of the wrong alleged' and the relief, if any, which could result if plaintiff were to prevail."[213] And despite disavowals of *Elster* in subsequent cases, *Kramer*'s articulation of the distinction between direct and derivative claims takes the phrase "nature of the wrong alleged" directly from *Elster* and unabashedly cites *Elster* as the source.[214]

Notwithstanding *Kramer*'s—very possibly inadvertent—articulation of another test for whether a claim is direct or derivative, the 1993 *In re Tri-Star Pictures, Inc*.[215] decision continued to use the "special injury" test.[216] In *Tri-Star*, the Delaware Supreme Court held that what would

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208 *See* Lewis v. Anderson, 477 A.2d 1040, 1048 n.15 (Del. 1984). In particular, the *Lewis* court reasoned that, to the extent that golden parachutes constituted breaches of fiduciary duty, an acquiring party also acquired the "chose in action" to recover for that breach. *See id.* at 1044. This reasoning is faulty in that there are significant costs to litigating a fiduciary duty breach, not the least being that an acquirer who sues a target's executives after closing the deal will likely find future acquisition targets to be much more resistant to a takeover. Furthermore, it may be difficult to financially recover even if a suit were brought, especially given Delaware's subsequent enactment of Del. Code Ann. tit. 8, § 102(b)(7) (2024) (exculpating directors from duty of care breaches). *Cf. In re* Massey Energy Co., No. 5430-VCS, 2011 WL 2176479, at *2 (Del. Ch. May 31, 2011) (failure to seek value for derivative claims in merger sale could constitute a breach of fiduciary duty). *See generally* New Enter. Assocs. 14, L.P. v. Rich, 292 A.3d 112, 170 n.49 (Del. Ch. 2023) (discussing the doctrinal impact of *Lewis*).

209 *Kramer*, 546 A.2d at 350 n.2, 352; Kramer v. W. Pac. Indus., Inc., No. 8675, 1987 WL 17043, at *3 (Del. Ch. Sept. 11, 1987); *cf.* Bershad v. Hartz, No. 6960, 1987 WL 6092, at *3 (Del. Ch. Jan. 29, 1987) (citing *Lewis* but ignoring the intervening enactment of section 102(b)(7)).

210 *Kramer*, 546 A.2d at 353, 355.

211 *Id.* at 354.

212 *See infra* Section III.B.

213 *Kramer*, 546 A.2d at 352 (quoting Elster v. Am. Airlines, Inc., 100 A.2d. 219, 223 (Del. Ch. 1953)).

214 *See id.*

215 634 A.2d 319 (Del. 1993).

216 *Id.* at 330.

later be called stock "overpayment" claims are direct.[217] In particular, the *Tri-Star* plaintiff had alleged that Coca-Cola, the controller of Tri-Star, caused Tri-Star to sell millions of its shares to Coca-Cola in exchange for Coca-Cola's essentially worthless entertainment division.[218] *Tri-Star* held that the transaction inflicted a "special injury" as the transaction "cause[d] a singular economic injury to minority interests alone" and diluted the minority's voting power.[219] Notwithstanding *Tri-Star*'s use of the maligned phrase "special injury,"[220] there was nothing objectionable about *Tri-Star*'s reasoning. The facts of the case indicated that Tri-Star suffered no economic harm in its own right and that the only injured parties were the minority shareholders, who saw their proportional ownership stake—and the value of that stake—decline precipitously.[221] Unfortunately, *Tooley* would later disclaim *Tri-Star* for "laps[ing] back into the 'special injury' concept."[222]

In the next significant case of *Grimes v. Donald*, the plaintiffs sought a declaration that the board "abdicated" its statutory and contractual duty by entering into an employment agreement with a CEO that "provid[ed] that the CEO 'shall be responsible for the general management of the affairs of the company' and further providing that the CEO can declare a constructive termination of the Employment Agreement for 'unreasonable interference' by the Board with the CEO."[223] *Grimes* did not use the phrase "special injury," instead citing to *Kramer*'s two-prong test.[224] Holding that the claim was direct, *Grimes* cited the ALI's *Principles of Corporate Governance*, which posited that director wrongdoing that violated a certificate of incorporation meant that the director had violated the contractual restraints imposed upon the director by shareholders via the corporate charter, giving rise to a claim that could be pleaded as both direct *and* derivative.[225] In further support of its decision, the court noted

217 *See id.* at 326–27, 330–33.

218 *See id.* at 320–23.

219 *Id.* at 332. Regarding the voting power claim, it is worth noting that "Coca–Cola could not vote its shares in favor of the proposal unless it was first approved by a majority of the minority shares voting," and the plaintiffs claimed that Coca-Cola provided incomplete and misleading information about the transaction to the minority. *Id.* at 325, 331.

220 *See* Tooley v. Donaldson, Lufkin, & Jenrette, Inc., 845 A.2d 1031, 1038 n.21 (Del. 2004) (quoting *Tri-Star*, 634 A.2d at 330).

221 *See Tri-Star*, 634 A.2d at 321–26.

222 *See Tooley*, 845 A.2d at 1038 n.21 (quoting *Tri-Star*, 634 A.2d at 330).

223 Grimes v. Donald, 673 A.2d 1207, 1210 (Del. 1996), *overruled in part by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000). *See generally supra* notes 113–16 and accompanying text.

224 *See Grimes*, 673 A.2d at 1213.

225 *Id.* (quoting Am. L. Inst., *supra* note 52, § 7.01 cmt. c). Notwithstanding the plaintiffs' characterization of the issue, the Court of Chancery found that the certificate of incorporation imposed the same obligations and rights as Del. Code Ann. tit. 8, § 141(a) (2024), and both allowed the board of directors to appoint officers to manage the operations of the corporation. *See* Grimes v. Donald, No. 13358, 1995 WL 54441, at *8 n.6 (Del. Ch. Jan. 11, 1995).

that the plaintiff sought prospective relief in the form of a declaration that the CEO's employment agreement was invalid, though neither the opinion nor the ALI publication it cites clearly explains *why* such prospective relief warrants treatment as a direct claim.[226] As discussed above, it was hard to see why the relief sought did not also benefit the corporation,[227] which would suggest derivative treatment, at least under *Tooley* and other traditional tests.

In the last significant case before *Tooley*, *Parnes v. Bally Entertainment* held that challenges to a merger's process and price constitute a direct claim, even though *Lewis* and *Kramer* reached the opposite conclusion on similar facts.[228] In *Parnes*, the plaintiffs alleged that the CEO essentially demanded a bribe from any would-be acquirer, that the board acquiesced in this misconduct, and that the merger price was hence unfair—with the last part supposedly distinguishing *Parnes* from *Lewis* and *Kramer*.[229] That said, the reasoning adopted in *Lewis* and *Kramer*—that inequitable conduct in the events leading up to a merger would not reduce the merger price as the buyer could simply sue the directors and officers after the merger to recover damages—would seem to apply to the *Parnes* fact pattern as well. Nevertheless, whereas *Lewis* and *Kramer* had held that claims regarding incentives to complete a merger were derivative, *Parnes* held that such claims were direct.[230] As with *Grimes*, although *Parnes* did not itself use the phrase "special injury," *Parnes* still relied primarily on *Kramer*—which did apply the special injury test—to articulate the differences between direct and derivative claims.[231]

To summarize, there were a few trends in Delaware's pre-*Tooley* caselaw. First, the courts struggled with how to even approach the question and had trouble stating a definitive test for whether a claim was

226 *See Grimes*, 673 A.2d at 1213. The ALI argues that when injunctive relief is requested, policy recommends treating a claim as direct because "the requested relief will not involve significant financial damages against corporate officials, the period in which the corporation is exposed to multiple suits will be relatively brief, and the relief will benefit all shareholders proportionately." Am. L. Inst., *supra* note 52, § 7.01 cmt. d. But that argument is unpersuasive, particularly when a plaintiff seeks the termination of an executive's contract. First, the relief requested seeks to essentially fire the executive, which rings of financial consequences, if not damages per se. Second, the multiplicity argument is not particularly compelling in any instance given that the Delaware courts can and do regularly consolidate shareholder claims into a single proceeding. *See, e.g.*, Jacksonville Police & Fire Pension Fund v. Moffett, No. 8110-VCN, 2013 WL 297958 (Del. Ch. Jan. 25, 2013). Third, that injunctive relief can *benefit* all shareholders means that a strike suit for injunctive relief, such as one seeking to remove a firm's CEO, can also *harm* all shareholders, suggesting that the protective mechanisms applicable to derivative suits should apply.

227 *See supra* notes 113–19.

228 Parnes v. Bally Ent. Corp., 722 A.2d 1243, 1245 (Del. 1999).

229 *See id.* at 1245–47.

230 *Id.*

231 *See id.* at 1245.

direct or derivative. Second, there was a remarkable amount of confusion on what constitutes a direct versus a derivative claim. That said, by the time *Tooley* was decided, Delaware courts had made at least some progress in reworking the flawed "special injury" test into something that can be applied logically and consistently, as evidenced by the well-reasoned decisions in *Tri-Star* and *Parnes*. However, *Tooley* would restart much of the didactical process.

B. Tooley *and the Post-*Tooley *World*

The facts in *Tooley* were that a tender offer was set to close on October 5, 2000, but was extended twice and finally closed on November 2, 2000.[232] The plaintiff challenged the second extension[233] and claimed as damages "the time-value of money lost" because of the extension.[234] The Court of Chancery concluded that the claim was derivative and dismissed on that basis, and the Delaware Supreme Court reversed that aspect of the ruling, reasoning that any damages from the claim would have gone to shareholders, not the corporation.[235]

As mentioned above, *Tooley* relied almost exclusively on case history to defend its condemnation of the special injury test and its introduction of a new two-pronged test.[236] But *Tooley*'s recitation of the case history was often flawed. Among other things, *Tooley* mischaracterizes *Lipton*, claiming that the *Lipton* court found a special injury because the plaintiff, unlike other shareholders, was "actively seeking to gain control of the defendant corporation."[237] But *Lipton* actually held just the opposite: "[The plaintiff] has not suffered any distinct harm . . . because as of the time of the complaint [the plaintiff] had *not* indicated a desire to use its holdings to gain control of the corporation."[238]

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232 Tooley v. Donaldson, Lufkin, & Jenrette, Inc., 845 A.2d 1031, 1034 (Del. 2004).

233 *Id.* The second extension was allegedly for the benefit of the target's majority shareholder. *Id.* at 1033–34. One presumes that this may have been the reason that the *Tooley* plaintiffs did not raise *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986), which requires a board to maximize shareholder profit when a sale is inevitable, as it may have seemed incongruous for the plaintiff to argue that the board was both acting for the benefit of a shareholder and yet failing to maximize shareholder profit. *See* Opening Brief of Appellants, *Tooley*, 845 A.2d 1031 (No. 84,2003), 2003 WL 23518413. *See generally* Brookfield Asset Mgmt. v. Rosson, 261 A.3d 1251, 1266–67 (Del. 2021) (noting that *Revlon* claims are direct).

234 *Tooley*, 845 A.2d at 1034.

235 *Id.* at 1034, 1039. That said, the Court of Chancery also found—and the Delaware Supreme Court agreed—that the plaintiff did not have a right to the proceeds of the tender offer before the closing date of the deal, and thus the plaintiff failed to state a claim upon which relief could be granted. *Id.* at 1039. Accordingly, the primary holding in *Tooley* is arguably dicta.

236 *See supra* text accompanying note 159; *see also Tooley*, 845 A.2d at 1036–39 (section titled "A Brief History of Our Jurisprudence").

237 *Tooley*, 845 A.2d at 1037–38.

238 Lipton v. News Int'l, Plc, 514 A.2d 1075, 1078–79 (Del. 1986) (emphasis added).

Tooley's criticisms of *Lipton* also overlook that *Lipton* had already resolved *Tooley*'s justified criticisms of *Elster* and *Bokat* by giving teeth to *Moran*'s contractual rights prong.[239] Furthermore, *Tooley* applauds *Kramer*, *Grimes*, and *Parnes*, seemingly ignoring that *Kramer* explicitly applies the "special injury" test that *Tooley* derides[240] and that *Grimes* and *Parnes* indirectly relied on the special injury test via their extensive reliance on *Kramer*.[241] *Tooley* does not try to reconcile the disparate results in *Kramer* and *Parnes* despite praising them both for supposedly leading the way to the new two-pronged test.[242] To the extent that the caselaw before *Tooley* supported *something*, it is far from clear that it supported *Tooley*'s reasoning and holding.

After *Tooley* came the unfairly maligned *Gentile v. Rossette*,[243] which was in fact a well-reasoned decision for the most part. The claim in *Gentile* resulted

> from a self-dealing transaction in which the CEO/controlling stockholder forgave the corporation's debt to him, in exchange for being issued stock whose value allegedly exceeded the value of the forgiven debt. The transaction, it [was] claimed, wrongfully reduced the cash-value and the voting power of the public stockholders' minority interest, and increased correspondingly the value and voting power of the controller's majority interest.[244]

The corporation was then acquired, and the question arose whether the plaintiffs, who were each preacquisition shareholders, had lost their standing to sue as a result of the acquisition.[245]

Thus, the ultimate question in *Gentile* was substantially similar to that in *Tri-Star*: when a shareholder obtains additional shares in exchange for allegedly inadequate consideration, do the remaining shareholders have a direct or derivative claim?[246] *Tri-Star* had answered the question by noting that such transactions do not "diminish[] the

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239 *Id.*; *see Tooley*, 845 A.2d at 1037–38.

240 *See Tooley*, 845 A.2d at 1036–39. It is perhaps also worth noting that *Tooley*'s summary of *Grimes* claimed that *Grimes* affirmed that the Court of Chancery's determination that the claim could be brought as a direct one was primarily "based on the relief requested," and ignored that *Grimes* only discussed the relief requested after quoting an ALI analysis that concluded that similar claims could be pursued either directly or derivatively. *Compare Tooley*, 845 A.2d at 1038, *with* Grimes v. Donald, 673 A.2d 1207, 1213 (Del. 1996), *overruled in part by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

241 *See supra* text accompanying note 231.

242 *See Tooley*, 845 A.2d at 1039.

243 906 A.2d 91 (Del. 2006), *overruled by* Brookfield Asset Mgmt. v. Rosson, 261 A.3d 1251 (Del. 2021).

244 *Id.* at 93.

245 *Id.*

246 *Compare id.*, *with In re* Tri-Star Pictures, Inc., Litig., 634 A.2d 319, 331 (Del. 1993).

value of all stockholders' interests equally" but rather "increase the value of the controlling stockholder's interest at the sole expense of the minority."[247] Accordingly, *Tri-Star* concluded that claims arising from such transactions were direct.[248] However, because *Tooley* had rejected the "special injury" test used in *Tri-Star*, the *Gentile* court was forced to analyze the question anew under the *Tooley* framework.[249] That said, it reached the same ultimate conclusion as *Tri-Star* and held that the instant claim was direct, particularly writing the following:

> Normally, claims of corporate overpayment are treated as causing harm solely to the corporation and, thus, are regarded as derivative. The reason (expressed in *Tooley* terms) is that the corporation is both the party that suffers the injury (a reduction in its assets or their value) as well as the party to whom the remedy (a restoration of the improperly reduced value) would flow. In the typical corporate overpayment case, a claim against the corporation's fiduciaries for redress is regarded as exclusively derivative, irrespective of whether the currency or form of overpayment is cash or the corporation's stock. Such claims are not normally regarded as direct, because any dilution in value of the corporation's stock is merely the unavoidable result (from an accounting standpoint) of the reduction in the value of the entire corporate entity, of which each share of equity represents an equal fraction. . . .
>
> 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. Because the means used to achieve that result is an overpayment (or 'over-issuance') of shares to the controlling stockholder, the corporation is harmed and has a claim to compel the restoration of the value of the overpayment. That claim, by definition, is derivative.

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247 *Tri-Star,* 634 A.2d at 330.

248 *Id.* at 321.

249 *See* Gentile v. Rossette, 906 A.2d 91, 99, 102 (Del. 2006).

> But, the public (or minority) stockholders also have a separate, and direct, claim arising out of that same transaction. Because the shares representing the 'overpayment' embody both economic value and voting power, the end result of this type of transaction is an improper transfer—or expropriation—of economic value and voting power from the public shareholders to the majority or controlling stockholder. . . . A separate harm also results: an extraction from the public shareholders, and a redistribution to the controlling shareholder, of a portion of the economic value and voting power embodied in the minority interest. As a consequence, the public shareholders are harmed, uniquely and individually, to the same extent that the controlling shareholder is (correspondingly) benefited. In such circumstances, the public shareholders are entitled to recover the value represented by that overpayment—an entitlement that may be claimed by the public shareholders directly and without regard to any claim the corporation may have.[250]

To break that down, *Gentile* is saying that when corporate overpayment has reduced the value of the entire corporate entity and each shareholder suffers pro rata due to that reduction in corporate value, then under *Tooley*, it cannot be held that there is an individual shareholder harm apart from the harm to the corporation. Such is the case when corporate overpayment involves a corporate payment of cash or some other nonstock asset in exchange for an asset of lesser value. But when a controlling shareholder engineers a dilution via a sale of stock for inadequate value, then such claims were at least partly direct under *Tooley*, as such a dilution directly injures the remaining shareholders via an impairment of value of their stock holdings that does not derive from any harm to the corporation.[251]

Yet just two years later, in *Feldman v. Cutaia*,[252] a three-justice panel of the Delaware Supreme Court, containing two out of the three *Gentile* justices, held that *Gentile* apparently did not mean that dilution claims are direct despite *Gentile* saying essentially just that.[253] As a preliminary note, it is understandable why the *Feldman* court sought to affirm the Court of Chancery's dismissal of the at-issue claim, which arose out of events

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250 *Id.* at 99–100 (footnotes omitted). The second paragraph is misguided for the reasons explained above that a corporation's unissued or treasury shares are not economically meaningful corporate assets. *Supra* Section II.C.

251 Although *Gentile* did not reach this issue, it is evident that a corporate overpayment of corporate nonstock assets in exchange for a shareholder's shares constitutes, at least in part, a direct claim, as in such an event, the shareholders would not have received equal treatment. *See* Tooley v. AXA Fin., Inc., No. 18414, 2005 WL 1252378, at *5 (Del. Ch. May 13, 2005).

252 951 A.2d 727 (Del. 2008).

253 *See id.* at 728, 735.

that occurred after the beginning of litigation. Essentially, the plaintiff had sold the vast majority of his stock for $3.36 per share around the time of a series of recapitalization transactions, which valued the company between $1.90 and $4 per share.[254] A few years later, the company also made a $10 per share repurchase offer.[255] The original complaint only stated claims concerning the recapitalization transactions and the share repurchase.[256] However, after the plaintiff filed his complaint, the firm was sold to a private equity firm for $14.87 per share.[257] It was only after that merger, which was approved by 92% of voting shares, that the plaintiff added the operative count, which claimed that the company's board had failed to investigate allegedly fraudulent stock options granted to the individual defendants.[258] All considered, it was hard to disagree with the defendants' characterization of the plaintiff as a "frustrated former stockholder, bitter at the fact that, had he not chosen to sell . . . , he would have received over $2 million just two years later."[259]

Still, *Feldman*'s reasoning that the plaintiff had not been directly harmed by the supposedly invalid stock options was strained at best.[260] *Feldman* read *Gentile* as meaning that a controlling shareholder is *necessary* for a dilution to result in a direct shareholder harm that gives rise to a direct claim.[261] But although *Gentile* involved a controlling shareholder, *Gentile* never held that a controlling shareholder was necessary for a dilution to cause a direct shareholder harm.[262] Still, *Feldman* cited *Gentile* to support its new proposition that "[i]n the absence of a controlling stockholder, 'such equal "injury" to the [company's] shares resulting from a corporate overpayment is not viewed as, or equated with, harm to specific shareholders individually.'"[263]

That proposition, however, does not follow from what *Gentile* said. Nowhere does *Gentile* claim that a controlling shareholder is required for an overpayment claim to be direct.[264] Despite the absence of a controlling shareholder requirement in *Gentile*, *Feldman* interpreted *Gentile* to be limited to "situations with a controlling shareholder"[265]

254 Feldman v. Cutaia, 956 A.2d 644, 648–49, 649 n.8 (Del. Ch. 2007).

255 *Id.* at 651.

256 *See id.* at 649, 651.

257 *Id.* at 652.

258 *See id.* at 652–53.

259 *Id.* at 653.

260 *See id.* at 659. Note that the outcome in *Feldman* may well have been alternatively justified by application of the business judgment rule or shareholder ratification, two issues that the court's decision did not reach. *See infra* note 351 and accompanying text.

261 *Feldman*, 956 A.2d at 659.

262 *See* Gentile v. Rossette, 906 A.2d 91, 99–100 (Del. 2006).

263 Feldman v. Cutaia, 951 A.2d 727, 732 (Del. 2008) (second alteration in original) (quoting *Gentile*, 906 A.2d at 99).

264 *See supra* notes 243–51 and accompanying text.

265 *See Feldman*, 951 A.2d at 732 n.26.

and held that, absent a controlling shareholder, corporate overpayment claims were invariably derivative.[266] Admittedly, *Gentile* held that "[t] here is, however, *at least one* transactional paradigm—a species of corporate overpayment claim—that Delaware case law recognizes as being both derivative and direct in character."[267] But *Gentile* did *not* say that the inverse of that statement is true—that the absence of a controlling shareholder transaction means a claim cannot be direct. *Feldman* does not—and cannot—explain why the presence of a controlling shareholder is required for a shareholder's personal voting power[268] or economic interests to be harmed by a dilutive transaction.[269]

In the following years, several Chancery and Delaware Supreme Court cases questioned *Gentile*. Most significantly, in *El Paso Pipeline v. Brinckerhoff*,[270] former Chief Justice Strine openly doubted "*Gentile*'s ongoing viability" in a concurring opinion.[271] *Gentile* was finally put on the chopping block by *Brookfield Asset Management v. Rosson*, a rare case in which the Court of Chancery recommended—and the Delaware Supreme Court accepted—interlocutory review on the premise that the at-issue "area of law . . . appear[ed] to be in a state of flux."[272]

Brookfield finally overturned *Gentile*, holding that (1) *Gentile* was an exception to the general *Tooley* rule,[273] (2) that *Gentile* is in tension with *Tooley*,[274] and that (3) *Gentile* is "superfluous."[275] The *Brookfield* court's criticisms of *Gentile* rely heavily on its interpretation of Delaware direct-derivative jurisprudence and the court devotes substantial space to arguing why the "special injury" concept is flawed and why

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266 *See id.* at 732–33.

267 *Gentile*, 906 A.2d at 99 (emphasis added).

268 If anything, a shareholder's voting power is *more* injured by a dilution where there previously was no controller, as the presence of a controller, by definition, means that other shareholders cannot generally win shareholder elections. *See, e.g.*, Paramount Commc'ns, Inc. v. QVC Network Inc., 637 A.2d 34, 42–43 (Del. 1994).

269 *Cf.* Brookfield Asset Mgmt., Inc. v. Rosson, 261 A.3d 1251, 1275 (Del. 2021); Carsanaro v. Bloodhound Techs., Inc., 65 A.3d 618, 659–60 (Del. Ch. 2013), *abrogated on other grounds by* El Paso Pipeline GP Co. v. Brinckerhoff, 152 A.3d 1248 (Del. 2016) (finding that a direct claim lay where there was an "inter-class conflict in which the directors favored themselves" over common shareholders despite the absence of a control group).

270 152 A.3d 1248 (Del. 2016).

271 *See id.* at 1265–66 (Strine, C.J., concurring). The Court's reasoning in *El Paso* was strange: after concluding that the at-issue duties were owed solely to the entity—a limited partnership—it nevertheless engaged in a *Tooley* analysis, suggesting that it is conceivable that breaches of duties owed solely to the entity might nevertheless be pressed directly by investors. *Id.* at 1260.

272 *In re* Terraform Power, Inc. S'holders Litig., No. 2019-0757-SG, 2020 WL 6889189, at *1 (Del. Ch. Nov. 24, 2020); *see also Brookfield*, 261 A.3d at 1255.

273 *Brookfield*, 261 A.3d at 1267.

274 *See id.* at 1261.

275 *See id.*

Gentile should not have compared itself to *Tri-Star*.[276] As explained above, although the 1950s version of the "special injury" test was admittedly problematic, the Delaware courts had made some meaningful progress in distinguishing between direct and derivative claims by the time of *Tooley*. Furthermore, although *Gentile* admittedly dedicates substantial verbiage to reconciling itself with *Tri-Star*, an independent *ratio decidendi* in *Gentile* is that its "result . . . fits comfortably within the analytical framework mandated by *Tooley*,"[277] which *Brookfield* seems to disregard. Finally, *Brookfield* does not convincingly explain why *Gentile*'s interpretation of *Tooley* is mistaken. Rather, in its attempt to discredit *Gentile*'s reasoning, *Brookfield* relies on (1) a supposed "general rule that equity dilution claims are solely derivative,"[278] (2) a unique interpretation of the word "dilution,"[279] and (3) limited policy justifications.[280] *Brookfield* then concluded that a challenge to a corporation's dilutive offering of stock for allegedly inadequate consideration was solely a derivative claim and, as a result of that corporation's subsequent merger acquisition, the shareholders challenging the dilutive offering had lost standing to maintain their action.[281]

However, as illustrated by cases such as *Bennett*, *Tri-Star*, and even *Grimes*, there is little basis for *Brookfield*'s claim that there is a "general rule that equity dilution claims are solely derivative."[282] Indeed, *Brookfield*'s citation for that claim is to an assertion from *El Paso* stating that there is a "general rule" that "claims of corporate *overpayment*" are generally derivative.[283] But, as discussed above, a proper understanding of the history and taxonomy of dilution and overpayment does not support such broad generalizations. Furthermore, this supposed "general rule" appears to have begun with *Gentile*,[284] which, as *Brookfield* would tell the story, in fact rejected the notion that there is a general rule

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276 *Id.* at 1264, 1269–71. Even so, *Brookfield*'s retrospective of the caselaw contains curious errors. For example, even though *Kramer* unambiguously holds in its conclusion section that "[t]he amended complaint may not be reasonably construed as alleging a 'special injury,'" Kramer v. W. Pac. Indus., 546 A.2d 348, 355 (Del. 1988), *Brookfield* strangely claims that *Kramer* never referred to a "special injury." *Brookfield*, 261 A.3d at 1271.

277 Gentile v. Rossette, 906 A.2d 91, 101–03 (Del. 2006) (describing three "separate" reasons for the decision).

278 *Brookfield*, 261 A.3d at 1275.

279 *See supra* Section II.C.

280 *See Brookfield*, 261 A.3d at 1267.

281 *See Gentile*, 906 A.2d at 99.

282 *Brookfield*, 261 A.3d at 1275.

283 *Id.* at 1275; El Paso Pipeline GP Co. v. Brinckerhoff, 152 A.3d 1248, 1261 n.60 (emphasis added) (quoting Caspian Select Credit Master Fund Ltd. v. Gohl, No. 10244-VCN, 2015 WL 5718592, at *5 (Del. Ch. Sept. 28, 2015)); *see Brookfield*, 261 A.3d at 1275 n.126.

284 *See, e.g.*, *Caspian Select Credit Master Fund*, 2015 WL 5718592, at *3 n.17 (quoting *Gentile*, 906 A.2d at 99).

that such claims are derivative.[285] Finally, although *Brookfield* criticizes *Gentile*'s supposed focus on the alleged wrongdoer, i.e., whether a controller was present,[286] *Brookfield* itself essentially conducts the same analysis in reverse by concluding that a dilution of minority shareholders' voting rights does not result in a cognizable harm or injury because the controller continues to hold all meaningful control rights.[287] Given these and the other problems with *Tooley* and other tests purporting to distinguish between direct and derivative claims, courts across the country should revisit their methods for determining the direct or derivative character of a shareholder claim.

IV. A Revised Distinction Between Direct and Derivative Claims

As shown by the foregoing, *Tooley*'s harm-recovery test for determining whether a claim is direct or derivative is an inapt tool for the job. Managers can often manipulate how injuries are inflicted upon corporations and shareholders, transforming direct claims into derivative claims. Likewise, evaluations of "who would receive the benefit of the recovery" is often indeterminate, not the least because equally equitable remedies can result in a recovery for either the corporation or for shareholders.[288]

Nor does it resolve the problem simply to say—as *Moran* did—that shareholders' contractual or individual rights may be pursued directly, whereas other claims must be pursued derivatively.[289]

As an initial matter, such a distinction fails as both a descriptive and logical matter because there is no singular syllogism between whether a shareholder holds some supposed contractual right and whether a shareholder may then bring a direct suit to enforce that right. It is true that the corporate contract[290] sets forth a shareholder's right to own and transfer shares as provided by the laws governing personal property and investment securities,[291] to obtain corporate books and records,[292] and to

285 *Cf.* Tiger v. Boast Apparel, Inc., 214 A.3d 933, 938 n.18 (Del. 2019); KT4 Partners LLC v. Palantir Techs. Inc., 203 A.3d 738, 762 (Del. 2019) (criticizing "norm[s]" that appear to have been invented from nowhere and subsequently cited as established fact).

286 *See Brookfield*, 261 A.3d at 1268.

287 *See id.* at 1281.

288 Tooley v. Donaldson, Lufkin, & Jenrette, Inc., 845 A.2d 1031, 1035 (Del. 2004); *supra* Section II.B.1.

289 *See* Moran v. Household Int'l, Inc., 490 A.2d 1059, 1070 (Del. Ch. 1985).

290 To be sure, the corporate contract is not limited to formal written documents signed and executed by the shareholder and the corporation; instead, it includes the statutory and common law of the jurisdiction of incorporation as well as any charter and bylaw provisions. *Supra* note 201.

291 *See, e.g.*, Del. Code Ann. tit. 8, § 159 (2024).

292 *See, e.g.*, *id.* § 220.

vote their shares.[293] But shareholders—at least in Delaware—also have the right to loyal, dutiful conduct by directors and officers.[294] And yet shareholders are often—and for good reason—limited to derivative suits when seeking redress for violations of that right. Indeed, as the Delaware Supreme Court wrote in *El Paso*, a post-*Tooley* case, it is not true that "any claim sounding in contract is direct by default."[295]

Moreover, the shareholder-rights criterion brings little closure as rights are defined by the law as society has made it: the question remains why the law should grant shareholders certain individual rights but not others?[296] For example, why would it be inappropriate to give shareholders an individual right to pursue a corporate claim against a corporate supplier? As such, just as the line between direct and derivative suits cannot be determined through a blinkered assignment of the loci of injuries and of remedies, neither can it be determined through a myopic recitation of shareholder rights.

Furthermore, the distinction between direct and derivative claims is only meaningful because of the higher burdens imposed on derivative claims. The discussion in this Article is only worth having because direct and derivative claims are treated differently in the courtroom. Even if there were some abstract, conceptual difference between direct and derivative claims, what justifies offering plaintiff-friendly processes in the former case but not the latter? For instance, why should it be easier to pursue claims that a director reduced shareholder returns by failing to maximize shareholder value in a merger, where direct *Revlon*[297] claims are available, and harder to pursue claims that a director reduced shareholder returns by failing to heed red flags in ongoing operations, where only derivative *Caremark*[298] claims are available? Likewise, given the possibility of board intervention after the suit via a *Zapata*[299]

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293 *See, e.g.*, *id.* § 212.

294 *E.g.*, New Enter. Assocs. 14, L.P. v. Rich, 292 A.3d 112, 144 (Del. Ch. 2023).

295 El Paso Pipeline GP Co. v. Brinckerhoff, 152 A.3d 1248, 1260 (Del. 2016).

296 *Cf.* Welch, *supra* note 39, at 160–65 (arguing that an inquiry into which rights the shareholder has personally retained suffices to determine which claims may be pursued directly, but also acknowledging that the rights and duties of the parties to the corporate contract varies by jurisdiction). Thus, that some jurisdictions hold that directors and officers owe fiduciary duties only to the corporation and not to shareholders may seem to resolve some of the complexities of the direct-derivative distinction in those jurisdictions, but many more problems arise without any fiduciary duties from directors to shareholders. *See* Int'l Bhd. of Elec. Workers Loc. No. 129 Benefit Fund v. Tucci, 70 N.E.3d 918, 920 (Mass. 2017) (rejecting *Revlon* duties in Massachusetts as directors of Massachusetts corporations do not owe duties to shareholders). For example, what would equitably constrain directors from simply canceling the stock of shareholders or diluting their shares to worthlessness in such jurisdictions once enough capital has been raised?

297 506 A.2d 173 (Del. 1986).

298 698 A.2d 959 (Del. Ch. 1996).

299 430 A.2d 779, 786 (Del. 1981).

committee,[300] what justifies the demand futility requirement at filing?[301] The mere delineation of some claims as individual and others as derivative does not answer this question.

Ultimately, to craft a consistent and useful test for whether a claim should be treated as direct or derivative, it should be remembered that shareholder suits are but one tool in an arsenal of procedural mechanisms to enforce the substantive bargain between shareholders and managers. The shareholder suit, although powerful, has numerous downsides when compared with other governance mechanisms such as the shareholder franchise.

For instance, because shareholder suits can be asserted by a single shareholder yet have corporation-wide effect, the rules governing shareholder suits must guard against strike suits that increase, rather than reduce, the frictions of the corporate form. Likewise, corporate law has long understood that courts are often flawed arbiters of business decisions.[302] Our decentralized economy presumes this principle, and historical experience has proven that government ministers and businesspeople are not generally suitable substitutes for one another.

A. A Statement of the Test

Therefore, a proper classification of shareholder claims into direct and derivative groupings should be based on the two factors that have always lain at the foundation of the distinction between direct and derivative claims: first and foremost, the availability of and relationship to other governance mechanisms to redress the substantive concern of the shareholder; and second, the relative competence of the judicial system to resolve the matter.

When applied, these two factors not only more clearly divide claims between direct and derivative groupings but also rationally explain courts' existing inclinations to treat some shareholder claims as derivative and others as direct. For instance, courts' general aversion to garden-variety claims of mismanagement is explained by both of these factors.

As to the first factor, shareholders asserting garden-variety mismanagement claims can resort to multiple other remedies provided for

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300 *See generally* Michael P. Dooley & E. Norman Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 BUS. LAW. 503, 509–13 (1989).

301 Compare the shareholder derivative action to qui tam actions under the Federal Claims Act ("FCA"). Note particularly the evolution of knowledge requirements under the FCA, which once forbade qui tam actions if the government had knowledge of the alleged misconduct. Christina Orsini Broderick, Note, *Qui Tam Provisions and the Public Interest: An Empirical Analysis*, 107 COLUM. L. REV. 949, 952–54 (2007).

302 *See, e.g.*, Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1153 (Del. 1989); Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 110–29 (2004).

by corporate law, not the least being the shareholder franchise. New directors not only can improve the management of the corporation but also can press the breach of fiduciary duty claims that might otherwise be asserted in a shareholder derivative suit.[303] Similarly, shareholders' right to obtain corporate books and records enables shareholders to better investigate possible wrongdoing, a process that may result in a derivative suit or a proxy contest.[304] Conversely, duly elected boards that reject an individual shareholder's demand for action do so with the implicit backing of the shareholder body.[305] Just as judicial review should generally refrain from nullifying the wishes of citizen majorities as expressed via elected representatives,[306] so too should judicial review refrain from nullifying the wishes of shareholder majorities as expressed via elected boards.

As to the second factor, the difficulties involved with second-guessing questions of business judgment weigh heavily in courts' decisions to place the heavy procedural burdens of derivative litigation upon mismanagement claims. Courts and commentators have noted that judges are necessarily ill-prepared to second-guess the business decisions of managers.[307] Absent extraordinary circumstances—which, by definition, garden-variety mismanagement is not—courts understandably defer to the judgments of properly constituted boards of directors.[308]

These factors also help explain why shareholders may not generally press direct claims against arm's-length third parties, even aside from the absence of a duty directly owed to shareholders.[309] For example, suppose

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303 *See, e.g.*, *In re* McDonald's Corp. S'holder Derivative Litig., 291 A.3d 652, 670 (Del. Ch. 2023).

304 *See* Roy Shapira, *Corporate Law, Retooled: How Books and Records Revamped Judicial Oversight*, 42 CARDOZO L. REV. 1949, 1958–59, 1980–84 (2021) (examining how courts have relaxed their interpretation of a Delaware statute granting shareholders the right to view books and records, allowing shareholder-plaintiffs to overcome former pleading hurdles and bring derivative suits more successfully).

305 *See* Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988) ("The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests."); *cf.* AM. L. INST., *supra* note 52, § 7.03, cmt. g (describing the demand requirement as partly an exhaustion requirement); Mark D. Seidelson, Note, *Variations on the Theme of Shareholder Derivative Actions: Changing the Tune of Rule 23.1 and the Beat of the Delaware Two-Step*, 57 GEO. WASH. L. REV. 363, 365 (1988).

306 *See* JOHN HART ELY, DEMOCRACY AND DISTRUST 181–83 (1980).

307 *See, e.g.*, *In re* The Walt Disney Co. Derivative Litig., 907 A.2d 693, 746 (Del. Ch. 2005); Gries Sports Enters., Inc. v. Cleveland Browns Football Co., 496 N.E.2d 959, 963 (Ohio 1986).

308 *In re Walt Disney*, 907 A.2d at 746–47.

309 3 CAROL A. JONES, FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS § 846 (rev. vol. 2010); *see also* Triton Constr. Co. v. E. Shore Elec. Servs., Inc., No. 3290-VCP, 2009 WL 1387115, at *10 (Del. Ch. May 18, 2009); *cf.* REV. MODEL BUS. CORP. ACT § 8.42 (2024). A rule that obligations owed to a corporation may generally be asserted only by the corporation essentially shows that the corporate veil is two-sided and represents the converse of the rule that obligations owed by a

a question arises over whether a nonexecutive employee has received excessive stock compensation or that a supplier received payment via equity and dividends rather than cash, as contemplated above.[310] Chaos would ensue if any shareholder could make a direct claim against such an employee or supplier. Instead, the governance factor would suggest that shareholders must resort to using their other governance powers to cause the corporation to enforce the claim, thus resulting in the rejection of the direct shareholder claim.

Note that the above analysis differs from the traditional "duty owed" test used by some courts regarding whether a claim may be asserted directly. Under the traditional "duty owed" analysis, breaches of duties owed to *both* shareholders and the corporation—such as the fiduciary duties of directors and officers—must be asserted derivatively.[311] However, the analysis of whether an act only breached duties to shareholders or breached duties to both shareholders and the corporation often rests on whether the corporation suffered harm.[312] As extensively described above, such a test is often readily manipulable.[313] Instead, this Article proposes that shareholders should be able to directly assert claims over breaches of duties that run to both the corporation and to individual shareholders, so long as the governance and judicial competency factors are met. Moreover, the duty owed analysis sheds little light on why some duties should be owed—or not—to shareholders versus the corporate entity.

That all said, there are three groups of claims that courts have historically allowed shareholders to press directly in greater or lesser amounts.[314] The first—and least controversial—category encompasses those shareholder rights that are often called "individual" or "contractual" shareholder rights.[315] The second category concerns nonratable (i.e., disproportionate) injuries, including, but not limited to, those

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corporation may not be asserted against the converse of the rule that obligations owed by a corporation may not be asserted against the corporation's individual shareholders. *See, e.g.*, IND. CODE § 28-13-2-3(b) (2024). However, such a rule alone does not answer which obligations—particularly fiduciary obligations—should be owed solely to the corporation and which obligations should also be owed to shareholders.

310 *See supra* note 92 and accompanying text.

311 *See, e.g.*, Marcuccilli v. Ken Corp., 766 N.E.2d 444, 451 (Ind. Ct. App. 2002) (holding that, because the injury accrued to the corporation, the duty breached to plaintiffs was not "separate and distinct from duties owed to the corporation and its other shareholders").

312 *Id.*; *cf.* El Paso Pipeline GP Co. v. Brinckerhoff, 152 A.3d 1248, 1265 (Del. 2016) (finding that, although a duty was owed solely to the partnership and not to limited partners such as the plaintiff, the question of whether the plaintiff could assert a direct claim should still turn on whether the plaintiff suffered harm separately from any harm to the partnership).

313 *See supra* Section III.A.1.

314 *See, e.g.*, Brookfield Asset Mgmt., Inc. v. Rosson, 261 A.3d 1251, 1269 (Del. 2021).

315 *See, e.g.*, Moran v. Household Int'l, Inc., 490 A.2d 1059, 1070 (Del. Ch. 1985).

inflicted by controlling shareholders.[316] And the final category covers merger-related claims.[317] This Article now turns to those three groups to discuss them in greater specificity and how this Article's proposed test improves clarity and fairness, particularly in the case of nonratable injuries.

1. The Treatment of Special Procedural Rights

This first category of claims often treated as direct involves so-called "individual" or "contractual shareholder rights," such as the right to vote or the right to books and records.[318] The factors proposed by this Article explain the traditional direct treatment of these claims well.

First, these individual shareholder rights are often the primary paths for seeking redress of the underlying concerns that motivate shareholder derivative suits. A corollary is that harms or injuries to these procedural shareholder rights often cannot be resolved through means other than the courts, as the very nature of such problems suggest that the ordinary gears of accountability may be jammed.[319] When voting rights are threatened, the courts may be the best or only method by which shareholders may reassert the rights of which they have been deprived. And, of course, without access to books and records—a right that encompasses access to shareholder registers[320]—it would be made much more difficult to conduct a successful proxy contest. In such cases, ready access to the courts—as enabled by the lower procedural barriers of direct shareholder claims—becomes more important in promoting well-functioning corporate governance and ensuring ultimate justice and efficiency.

Second, questions of process and procedure often take center stage in the individual shareholder rights that shareholders traditionally protect via direct suits, whereas questions of business and economic judgment often lead the way in mismanagement claims. It is no coincidence that lawyers and courts are usually thought to be much more

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316 *See id.*

317 *See* Parnes v. Bally Ent. Corp., 722 A.2d 1243, 1245 (Del. 1999) (discussing the standard for bringing a direct claim concerning a merger).

318 *Moran*, 490 A.2d at 1070.

319 *Cf.* Lucas v. Forty-Fourth Gen. Assembly of Colo., 377 U.S. 713, 753–54 (1964) (Stewart, J., dissenting) (rejecting apportionment plans that "permit the systematic frustration of the will of a majority"); Condec Corp. v. The Lunkenheimer Co., 230 A.2d 769, 777 (Del. Ch. 1967) (noting it is the "very heart of corporate representation" that "a stockholder with an equitable right to a majority of corporate stock [should] have his right to a proportionate voice and influence").

320 *See, e.g.*, State *ex rel.* Grismer v. Merger Mines Corp., 101 P.2d 308, 311 (Wash. 1940) (collecting cases from multiple states to support the rule that "the share register or list of shareholders" is included as part of "the books and records of the corporation which [a] shareholder is entitled to inspect").

competent when it comes to judging questions of process and procedure as opposed to the economic substance of business transactions.[321]

2. *The Treatment of Nonratable Harms*

Injuries arising out of treatment that is worse than that afforded to other similarly situated shareholders, i.e., whether a shareholder suffered a nonratable harm or injury, also frequently prompts treatment of litigation as a direct claim. Indeed, a long string of caselaw has identified injuries "separate and distinct from that suffered by other shareholders" as ones appropriate for resolution via a direct claim.[322]

However, those decisions often strangely elide *why* such claims should be treated as direct,[323] though the answer is not particularly mysterious. A board elected to represent the collective interests of shareholders cannot be expected to remedy a single shareholder's complaint that, if addressed, could negatively impact all other shareholders.[324] And in the case of controller self-dealing, it should be evident that boards that, by definition, are selected by the controller cannot be expected to adequately protect minority shareholders from the predations of the controller.[325] In these cases, ordinary nonjudicial governance mechanisms can be of little help to a complaining shareholder and judicial process is crucial to a meaningful likelihood of redress. That is to say, when the nonratable benefit accrued to a shareholder due to the shareholder's voting power, the nonratable benefit should be subject to challenge via a direct claim.

For instance, the facts of *Bokat*—"basically that Getty Oil, through its control of Tidewater, caused it to invest large amounts of money for the construction of foreign refineries and marine terminals to receive large amounts of foreign crude oil sold to it by Getty Oil at an inflated price"[326]—should therefore be subject to a direct claim. A direct claim

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321 James An, *Substance and Process in Corporate Law*, 20 N.Y.U. J.L. & Bus. 187, 235–38 (2024).

322 *Supra* Section III.A.

323 It is unsurprising that cases such as *Tooley* and *Brookfield* do not explain why separate and distinct injuries should constitute direct claims—after all, they reject the notion altogether. Tooley v. Donaldson, Lufkin, & Jenrette, Inc., 845 A.2d 1031, 1038–39 (Del. 2004); Brookfield Asset Mgmt., Inc. v. Rosson, 261 A.3d 1251, 1273 (Del. 2021). What is more perplexing is why cases such as *Moran* that support the separate-and-distinct rule omit any logical defense of why such injuries should give rise to direct claims. *See Moran*, 490 A.2d at 1069–70.

324 Likewise, in democracies, minority oppression often calls for heightened judicial review, as minorities, by definition, do not command sufficient votes to protect any idiosyncratic interests that they might have. *See* United States v. Carolene Prods. Co., 304 U.S. 144, 152 n.4 (1938).

325 *Cf.* Leo E. Strine Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face*, 30 Del. J. Corp. L. 673, 678 (2005) ("Delaware is more suspicious when the fiduciary who is interested is a controlling stockholder.").

326 Bokat v. Getty Oil Co., 262 A.2d 246, 248 (Del. 1970).

is appropriate not because of an undisputedly confusing consideration of whether a "special injury" occurred but because a board serving at the pleasure of a controller cannot be expected to adequately police self-dealing by that controller. For similar reasons, facts such as those from *Sciabacucchi v. Liberty Broadband Corp.*,[327] in which the plaintiff alleged that a board had issued stock and a voting proxy to the corporation's largest shareholder on unfair terms, should also give rise to a direct claim.[328]

This proposed approach resolves the incentive for controllers or other major shareholders to reorganize transactions whose economic substance is plainly abusive of minority shareholders into "dilution" transactions that are treated as derivative claims. For example, take the four functional squeeze-outs of Corporation X shareholders in Section II.A.1 above. Using a naïve lens, pro rata treatment occurred in all but the cash squeeze-out, as all the shares were reduced in value, even though all four transactions effectively harmed minority shareholders for the benefit of the controller. The problem is that the controller stood on the other side of the transaction in all four examples, extracting nonratable benefits as a counterparty even while all shareholders nominally paid for those benefits in a pro rata fashion. This approach also avoids the perplexing assertion under current doctrine that corporations are somehow injured by transactions that leave them with more assets, as was the case in *Brookfield* and *Sciabacucchi*.[329]

Conversely, without some accompanying governance-related cause or impediment to fair resolution, nonratable harm is insufficient alone to justify more plaintiff-friendly judicial procedure. Where the shareholders who did not receive a benefit collectively had the power to render the corporate decision—or elect those who did render the decision—a dissident from among that group should not be able to attack the corporate decision via a direct suit merely by claiming individual harm. For example, suppose a single director or officer is alleged to have breached their fiduciary duties by stealing from the corporate till, perhaps by drawing compensation in excess of their contractual

327 No. 11418-VCG, 2018 WL 3599997 (Del. Ch. July 26, 2018).

328 *See id.* at *5. Notwithstanding any question-begging logic in *Sciabacucchi* that the claims were derivative because stock "overpayment" is a derivative claim, the Court of Chancery, which admittedly is bound by the Delaware Supreme Court's holdings, did not and could not identify any actual harm or injury to the corporation from the at-issue transactions. *Id.* at *17–18.

329 *See* Brookfield Asset Mgmt., Inc. v. Rosson, 261 A.3d 1251, 1275–76, 1281 (Del. 2021) (citing *Sciabacucchi*, 2018 WL 3599997, at *10). The *Brookfield* rule also leads to the strange conclusion that, if a flip-in poison pill were to be triggered, the would-be hostile acquirer could only bring a derivative suit for the injuries arising from the economic dilution of his stock. The hostile acquirer would be left arguing that somehow the corporation was injured because other equity holders poured additional investment into the corporation.

allowance.[330] Allowing a shareholder to sue the director or officer directly, particularly where there is no conflict of interest preventing the rest of the board from pursuing remedial action, may present a serious distraction and expense for the corporation, particularly given that the corporation may be liable for advancement and indemnification of the defendant's expenses.[331] In such cases, the corporation's elected managers may generally be trusted, and shareholder complaints should be subject to the burdens of a derivative suit.

Indeed, there are situations where dilutive stock issuances *should* be treated as derivative claims, not the least being most cases of stock compensation for executives and employees. Under this Article's proposed approach, absent self-interest by a controller or another large shareholder capable of exercising disproportionate influence, claims relating to executive or employee compensation would continue to be treated as derivative claims, as each of the remaining shareholders who are harmed collectively had the power to have indirectly chosen otherwise. As courts implicitly recognize, any other rule would allow meddlesome shareholders to disrupt ordinary business operations, create unwarranted disincentives to stock compensation, and even expose employees to litigation risk.[332] This approach thus solves the primary problem that has plagued courts regarding the direct-derivative distinction: how to sensibly and rationally distinguish between dilutions—which all affect the rights of individual shareholders—that should and should not be subject to direct claims.

3. *The Treatment of Merger Claims Absent a Controller Conflict*

Finally, merger-related claims, such as claims like in *Revlon v. MacAndrews & Forbes Holding, Inc.*[333] that allege a board failed to follow a process that would maximize shareholder returns, are also generally treated as direct claims even absent a controller conflict.[334] Existing caselaw justifies the treatment of merger claims as direct because (1) an unfair or invalid merger agreement injures only shareholders and not the corporation,[335] and (2) the duty to maximize sale price is owed to shareholders.[336]

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330 Note that such a claim would likely not be protected by the business judgment rule or section 102(b)(7) exculpation as it implicates a violation of the duty of loyalty.

331 *See* DEL. CODE ANN. tit. 8, § 145 (2024).

332 *See supra* notes 206–11.

333 506 A.2d 173 (Del. 1986).

334 *See id.* at 182.

335 *See* Parnes v. Bally Ent. Corp., 722 A.2d 1243, 1245 (Del. 1999).

336 *See* Murphy v. Inman, 983 N.W.2d 354, 368–72 (Mich. 2022). Admittedly, some jurisdictions do not hold that there is a duty to maximize sale price that flows to shareholders. In such jurisdictions, *Revlon* claims cannot be made at all. *See* Int'l Bhd. Of Elec. Workers Loc. No. 129

As this Article shows, however, such justifications do not well explain why different transactional structures that have similar economic effects are nevertheless treated differently. As illustrated above, the substantive economics of an unfair merger sale can sometimes be reworked as an unfair cash purchase that wreaks substantially identical economic harm upon the same underlying shareholders.[337] But shareholders may pursue unfair merger claims directly, whereas challenges to cash purchases generally must proceed derivatively. By contrast, this Article's two-factor analytical framework captures far more sensible explanations for this disparate treatment.

Most importantly, the merger sale extinguishes the ability of premerger shareholders to replace the board.[338] Nonjudicial corporate governance mechanisms are largely eliminated by mergers, and litigation becomes the primary avenue by which shareholders can seek redress. On the other hand, with a cash purchase, shareholders retain the same governance rights that they had before the transaction.

Relatedly, the *Corwin v. KKR Financial Holdings LLC*[339] doctrine, which allows informed, uncoerced shareholder approvals to cleanse merger deals not involving a controlling shareholder of any associated breach of fiduciary duty claim,[340] follows as a corollary. After all, the sort of serious breach of fiduciary duty that can serve as the predicate for unfair merger claims will result in an uninformed or coercive vote,[341] the results of which may be unresolvable through further exercise of voting rights. As such, with *Corwin*, any actionable breach of fiduciary duty in

Benefit Fund v. Tucci, 70 N.E.3d 918, 926–27 (Mass. 2017). The full implications of such doctrines are beyond the scope of this Article.

337 *See supra* Section II.A.1.

338 Even in stock-for-stock mergers, the power of shareholders to seek redress via the ballot is obviously reduced—often greatly—after the merger.

339 125 A.3d 304 (Del. 2015).

340 *Id.* at 305–06.

341 One commenter raised to this Author the excellent question of whether unfair asset sales should result in a direct claim, particularly given that unfair asset sales can be used to replicate, or nearly replicate, the economics of an unfair merger. Here, because Del. Code Ann. tit. 8, § 271 (2024) gives shareholders the right to vote on material asset sales, a violation of that right where the vote was uninformed or coercive should likewise result in a direct claim. Relatedly, another commenter asked about the relationship of such a framework and the conduct in *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1146–49, 1155 (Del. 1989), in which the directors sidestepped a vote that would have been required under New York Stock Exchange rules—but not Delaware law—by restructuring a transaction. The Author agrees with courts that have rejected efforts by shareholders to seek redress for violations of stock exchange rules via direct claims for breach of fiduciary duty, provided that no controller conflict of interest was involved. *See, e.g.*, Teamsters Union 25 Health Servs. & Ins. Plan v. Baiera, No. 9503-CB, 2015 WL 4192107, at *19 (Del. Ch. July 13, 2015). Of course, inequitable avoidance of state corporate law voting rights is another matter entirely. *See* Paramount Commc'ns Inc. v. Time Inc., Nos. 10866, 10670, and 10935, 1989 WL 79880, at *25–26 (Del. Ch. July 14, 1989).

a merger also involves, within the course of misconduct, a violation of shareholder voting rights, which should be considered direct claims.

In addition, the risk of judicial error is higher with claims of cash overpayments than claims of merger unfairness. This is because the significance of a merger sale is unquestionable, and therefore a per se rule giving plaintiffs greater access to the courts in such cases is sensible and workable. On the other hand, the significance of an asset purchase is more uncertain—firms make many purchases, including quite large ones, in the ordinary course of business. In passing judgment upon a corporate purchase, a court may mistakenly take a misguided ordinary-course purchase for an undutiful major transaction, a risk that supports higher procedural burdens.

B. *Practical Impacts and Responses to Practicality-Based Critiques*

As noted above, the errors in courts' determination of whether a claim is direct or derivative have generally gone one way: claims that should have been held to be direct were instead held to be derivative. Although they have not explicitly stated as such, Delaware courts seem to be concerned that allowing dilution claims as direct claims would result in plaintiffs flooding the courts with ultimately meritless claims that nevertheless are able to proceed past dismissal.

For example, the *Feldman* court, understandably and reasonably, seemingly did not want to allow a dilution claim to proceed past dismissal where the at-issue claim arose only after the beginning of litigation, where it was hard to argue with the defendants' label of the plaintiff as a disgruntled shareholder who sold his shares at the bottom.[342] Similarly, *Brookfield* appeared to be concerned that allowing any loss of voting power to give rise to a direct claim would invite excessive litigation.[343] Because of the lower hurdles associated with direct claims, treating more claims as direct claims could increase the volume and burdens of litigation.

But there are several problems with such reasoning. For one, the higher hurdles associated with derivative claims, not the least being demand futility, may be unjustified when a claim is made against a controller. In defense of demand futility in this context, it has been argued that independent directors of controlled corporations can nevertheless be regularly expected to hold controllers accountable.[344] However, the arguments cited in defense of the power of independent directors to

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342 *Supra* notes 252–59 and accompanying text.

343 Brookfield Asset Mgmt., Inc. v. Rosson, 261 A.3d 1251, 1281 (Del. 2021) (no plausible claim of voting power loss because plaintiff failed to plead that the controller would have "relinquish[ed] . . . majority control").

344 *See* Lawrence A. Hamermesh, Jack B. Jacobs & Leo E. Strine Jr., *Optimizing the World's Leading Corporate Law: A Twenty-Year Retrospective and Look Ahead*, 77 BUS. LAW. 321, 359–61 (2022); *cf.* Strine, *supra* note 325, at 678.

check controlling shareholders are remarkably weak. For instance, these arguments conflate independence from corporate executives—such as C-suite officers—with independence from controllers.[345] But director independence from controllers is much harder to attain than director independence from officers. After all, officers are hired and fired by directors, whereas the controller is the one who hires and fires directors. Likewise, the claim that public-facing forces such as the media or proxy advisors will protect minority investors[346] seems unwarranted, given that most Delaware corporations are privately held companies that receive little outside attention.[347]

Moreover, a meritless direct claim is still subject to dismissal under Chancery Rule 12(b)(6) for failure to state a claim. For instance, in *Feldman*, the plaintiff alleged little to suggest that he could overcome the protections of the business judgment rule, which should protect the board against even direct claims where the plaintiff cannot allege facts that rebut the rule's presumption of disinterestedness and good faith.[348] And even if the plaintiff pleads that enhanced scrutiny applies,[349] they must also plead facts adequate to suggest that the dilution cannot survive that enhanced scrutiny.[350] And in *Feldman*, notwithstanding the Court of Chancery's dismissal for lack of standing, the trial court also found that it was reasonable to infer the plaintiff and other nonparticipating shareholders had—but passed on—the opportunity to participate in the allegedly dilutive financing rounds at issue.[351] Similarly, the claim in *Feldman* that the company's $10 stock buyback wrongfully impaired the company's capital is a serious stretch, given that the company was acquired the following year for almost fifty percent more per share.[352] As such, even if the court in *Feldman* treated the plaintiff's claims as direct, the plaintiff may well have failed to allege facts plausibly indicating actual unfairness sufficient to survive a Rule 12(b)(6) motion.

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345 *See* Hamermesh et al., *supra* note 344, at 341.

346 *Id.* at 341–42.

347 *See* Brief of Academics as Amici Curiae Supporting Appellants at 5–6, *In re* Match Group, Inc. Derivative Litigation, 315 A.3d 446 (Del. 2024) (No. 368, 2022).

348 Feldman v. Cutaia, 956 A.2d 644, 659 n.52 (Del. Ch. 2007); *see, e.g.*, *In re* Hennessy Cap. Acquisition Corp. IV S'holder Litig., 318 A.3d 306 (Del. Ch. 2024).

349 As would be the case where entrenchment is adequately pleaded. *See* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1373 (Del. 1995).

350 *See* Malpiede v. Townson, 780 A.2d 1075, 1083–84 (Del. 2001); *see also* Monroe Cnty. Emps.' Ret. Sys. v. Carlson, No. 4587-CC, 2010 WL 2376890, at *1 (Del. Ch. June 7, 2010) (dismissing for failure to state a claim despite enhanced scrutiny); Ravenswood Inv. Co., L.P. v. Winmill, No. 3730-VCN, 2011 WL 2176478, at *4 (Del. Ch. May 31, 2011) (same); Capella Holdings, Inc. v. Anderson, No. 9809-VCN, 2015 WL 4238080, at *5–6 (Del. Ch. July 8, 2015) (same).

351 *Feldman*, 956 A.2d at 658–59.

352 *Id.* at 651, 661.

And to the extent that treating more claims against controllers as direct claims circumvents aspects of *Aronson v. Lewis*[353] and *United Food & Commercial Workers Union v. Zuckerberg*,[354] so be it.[355] It is past time that corporate law moved on from the parts of *Aronson* that require courts to engage in a complex and unpredictable investigation of the supposed independence of directors in controlled corporations. The results of *Aronson* are that one court can find "clearly" no reasonable doubt of independence between two businesspeople with a friendship so close that it merited a magazine article,[356] while another court can find a chief financial officer's ("CFO") thriving and lengthy career at a firm, by the very virtue of its success and longevity, creates "very warm and thick personal ties" between that CFO and their bosses.[357] At best, such doctrines result in legal uncertainty that invariably increases the costs and risks of doing business. In any event, there is no good reason to think that courts cannot dismiss meritless claims merely because the demand requirement would not suffice for that purpose. Courts have proven that they are more than capable of dismissing suits against controlling shareholders for failure to state a claim,[358] and they are undoubtedly more than capable of doing so even when controllers can no longer manipulate the direct-derivative divide to their favor.

Furthermore, it is far from certain that more nominally permissive rules would lead to more litigation. First, a clearer, more readily applied judicial rule may well promote out-of-court resolutions. Second, if fewer procedural hurdles in litigation meant that corporate boards acted with greater care and faithfulness, such changes in substantive conduct may lead to less litigation.

The Delaware courts have also raised other less than convincing concerns about treating more claims as direct rather than derivative. For example, *El Paso* and *Brookfield* claimed that allowing dilution claims to proceed as direct claims is unnecessary where there is a change of control, as other doctrines such as *Revlon* might apply.[359] As *El Paso* and *Brookfield* argued, the availability of *Revlon* claims—which are direct

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353 473 A.2d 805 (Del. 1984).

354 262 A.3d 1034 (Del. 2021).

355 *See Aronson*, 473 A.2d at 814–15 (in evaluating demand futility in derivative claims against controllers, requiring a director-by-director examination of the personal relationship between controller and the board reviewing any putative demand); *Zuckerberg*, 262 A.3d at 1047–59 (same).

356 Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1054 (Del. 2004).

357 *See* Marchand v. Barnhill, 212 A.3d 805, 818–19 (Del. 2019). The Delaware courts have also held that "[c]o-ownership of a private plane" is a significant fact that gives rise to an inference "of a continuing, close personal friendship." Sandys v. Pincus, 152 A.3d 124, 130 (Del. 2016).

358 *See, e.g.*, *supra* note 350 (citing cases with examples).

359 El Paso Pipeline GP Co. v. Brinckerhoff, 152 A.3d 1248, 1266 (Del. 2016) (Strine, C.J., concurring); Brookfield Asset Mgmt., Inc. v. Rosson, 261 A.3d 1251, 1276 (Del. 2021).

claims of breach of fiduciary duty in change-of-control transactions that are subject to a heightened standard of review[360]—obviates the need for a "separate" direct claim for wrongful dilution under *Tooley*.[361] However, such reasoning does not recognize that (1) legal claims often overlap without drawing concern—nobody seems particularly concerned that a wrongful termination might be pleaded as a half dozen common law and statutory claims or that a false statement concerning a nonpublic figure might be pleaded as a number of dignitary torts; (2) there are instances of dilution that do not involve a subsequent change of control, and neither *El Paso* nor *Brookfield* explain why suffering shareholders should be subject to the constraints of a derivative claim in such cases; and (3) such logic fails to address why *Revlon* claims should be considered direct in the first place.

Brookfield also complained that allowing dilution claims to proceed as direct claims could lead to double recovery if a parallel derivative suit is brought concerning the dilution.[362] However, as with *Brookfield*'s invocation of *Revlon*, the specter of double recovery should not be considered a serious impediment to treating dilution claims as direct. First, *Brookfield* could have just as easily obviated any concerns over double recovery by allowing the at-issue claim to only proceed directly, which is the result that this Article suggests. Second, the avoidance of some analytical difficulty hardly seems like a sufficient justification for imposing material barriers on a plaintiff's ability to seek recompense for breaches of fiduciary duty.[363] And third, there is no evidence that preventing double recovery, even if there were parallel direct and derivative claims, would be a more complicated process than wading through the doctrinal tangle that exists now.

None of this is to say that direct claims, much less shareholder claims in general, cannot possibly be abused. In modern corporations where ownership is widely dispersed and litigation costs are high, it would be more than possible—absent adequate controls—for individual shareholders, and their attorneys, to essentially extract wealth from other shareholders by filing a frivolous suit and then settling that suit for nominal recompense but substantial attorneys' fees.[364] Accordingly, prudent modern regulation of internal corporate affairs must go beyond traditional notions of agency costs, whereby agents, i.e., management, improperly extract wealth from

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360 *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986).

361 *Id.*

362 *Brookfield*, 261 A.3d at 1277.

363 *See* Thorpe v. CERBCO, Inc., No. 11713, 1993 WL 443406, at *12 (Del. Ch. Oct. 29, 1993); *cf.* Thorpe *ex rel.* Castleman v. CERBCO, Inc., 676 A.2d 436, 445 (Del. 1996).

364 *In re* Trulia, Inc. S'holder Litig., 129 A.3d 884, 891–92 (Del. Ch. 2016).

principals, i.e., shareholders; modern corporation law must also protect shareholders from other shareholders.[365]

But as Delaware courts have already shown, there are far more targeted and effective methods to deal with vexatious litigants and their attorneys. For instance, *In re Trulia, Inc. Shareholder Litigation*[366] showed how courts can reject class action settlements—and fee awards—that provide class members with inadequate compensation,[367] thus deterring meritless class actions suits from being filed in the first place—at least in Delaware courts.[368] Likewise, Delaware recently raised the standard for plaintiffs' attorneys to obtain mootness fees.[369] And with the rise of forum selection clauses in corporate charters,[370] Delaware corporations can ensure that such suits are heard in Delaware courts that will have expertise in the substantive nature and proper procedural treatment of shareholder claims.[371] Courts should be managing frivolous or "deal-tax" litigation with these tools, not with ham-fisted distinctions between direct and derivative claims.

Conclusion

The direct versus derivative distinction has long been derided as confusing and abstruse. One may even question the utility of the distinction, given that the human persons who suffer from the misconduct targeted by either direct or derivative suits are the same shareholders of the corporation.[372]

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365 Note that the harms warned against here need not be inflicted by majority shareholders—indeed, a minority shareholder is far more likely to file a strike suit.

366 129 A.3d 884 (Del. Ch. 2016).

367 *Id.* at 884, 891–99.

368 *See* Matthew D. Cain, Jill Fisch, Steven Davidoff Solomon & Randall S. Thomas, *The Shifting Tides of Merger Litigation*, 71 Vand. L. Rev. 603, 608–09 (2018).

369 Anderson v. Magellan Health, Inc., 298 A.3d 734, 748 (Del. Ch. 2023).

370 *See generally* Del. Code Ann. tit. 8, § 115 (2024); Salzberg v. Sciabacucchi, 227 A.3d 102, 116–17 (Del. 2020).

371 *Cf.* Emma Weiss, Comment, In re Trulia*: Revisited and Revitalized*, 52 U. Rich. L. Rev. 529, 552–55 (2018) (proposing enhancements to Del. Code Ann. tit. 8, § 115). As to the issue of mootness fees paid in meritless federal securities class actions, it does not seem like Delaware state courts alone can resolve that problem and Delaware courts should not create a self-inflicted wound upon its corporate law doctrine that solves little. *See* Matthew D. Cain, Jill E. Fisch, Steven Davidoff Solomon & Randall S. Thomas, *Mootness Fees*, 72 Vand. L. Rev. 1777, 1809 (2019); Lawrence A. Hamermesh, *How Long Do We Have to Play the "Great Game"?*, 100 Iowa L. Rev. Bull. 31, 37–38 (2015) (recommending changes to federal policy and procedural rules).

372 Note that the plaintiffs who bring derivative claims are the same as the ones who bring direct claims. *Compare* Brookfield Asset Mgmt., Inc. v. Rosson, 261 A.3d 1251 (Del. 2021), *with* Verified S'holder Class Action Complaint, City of Dearborn Police & Fire Revised Ret. Sys. (Ch. 23) v. Brookfield Asset Mgmt., Inc., No. 2022-0097, 2024 WL 3179328 (Del. Ch. June 25, 2024), 2022 WL 355333.

Nevertheless, the bifurcation of shareholder claims into direct and derivative is useful for the same fundamental reason that the corporate form is useful: it facilitates business. Therefore, the ultimate basis for the distinction between direct and derivative claims—and all the attendant burdens imposed upon derivative claims but not direct claims—cannot rest upon formalistic conceptions of corporate versus individual shareholder rights and duties, not least because the question merely shifts to why corporate law should define the formal rights and duties of the parties in one way versus another. Instead, the foundation for the direct-derivative distinction must include a normative evaluation of why some claims should be easier to press than others.

However, the current legal tests examining the direct-derivative distinction have lost sight of that goal by instead looking toward readily manipulable legal formalities. Corporate fiduciaries can often reroute shareholder injuries through the corporation by modifying the form but not the substance of a transaction. Likewise, evaluations of the formal beneficiary of a recovery depend on the court's announced remedy, which might take multiple forms while remaining fair. The current test thus results in uncertainty and inefficiency at best, inequity and injustice at worst.

Furthermore, these tests cannot be fixed simply by rallying around formalisms such as what constitutes "corporate" versus "shareholder" harms. Although careful analyses of these formalisms shed light on issues within existing law, relying on formalisms alone will not make for materially better law. We will have gained nothing of value by forcing stock transactions and cash transactions to be litigated differently on those bases alone, even if doing so would align with a formalistic division of corporate versus shareholder interests.

Instead, this Article proposes a path that is hopefully both more straightforward and more rooted in sound policy by looking to fundamental procedural considerations of how collective decision-making and conflict resolution should be conducted within the corporate form. And although a reasonable observer should not expect a new paradigm in the immediate future,[373] the hope is that one day, the direct-derivative distinction will be described not as "subjective," "opaque," or "muddled" but rather as a useful and illuminating device within the corporate law toolbox.

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[373] *See Brookfield*, 261 A.3d at 1280.