

## **Delaware Supreme Court Recognizes Expanded Scope of Direct Shareholder Claims**

In *Gatz v. Ponsoldt*, 2007 WL 1120338 (Del. Apr. 16, 2007), the Delaware Supreme Court, *en banc*, held that public shareholders could bring direct claims, in addition to derivative claims, to challenge a series of transactions orchestrated by a controlling shareholder that transferred voting power and economic value from the public shareholders to a third party, and ultimately benefited the controlling shareholder. The decision indicates that Delaware courts will look to the substance rather than the form of corporate transactions in determining whether they give rise to direct claims by shareholders. The distinction between direct and derivative claims is important because, unlike direct claims, derivative claims are subject to the requirement under Rule 23.1 of making a pre-suit demand on the corporation's board or pleading why a demand would be futile. Also, many derivative claims are released or discharged in bankruptcy proceedings.

At issue in *Gatz* was a complex recapitalization (the "Recapitalization") of Regency Affiliates, Inc. ("Regency"), which was allegedly orchestrated by William R. Ponsoldt, Sr. ("Ponsoldt") through Statesman Group, Inc., an entity controlled by Ponsoldt that owned 40% of Regency. The Recapitalization resulted in a significant payment to Statesman, and a transfer of voting control of Regency to Royalty Holdings, L.L.C. ("Royalty"), an entity owned by Laurence Levy. The public shareholders received nothing and were significantly diluted. Specifically: (a) Royalty provided \$4.75 million cash to Regency for financing the transaction and received, among other things, approximately 60% of Regency's common stock; (b) Statesman received, among other things, \$4 million of the \$4.75 million cash provided by Royalty; (c) Regency received \$250,000 of the \$4.75 million cash provided by Royalty; and (d) Regency's minority shareholders received no financial benefit from the Recapitalization and their combined stock ownership was diminished from approximately 62% to approximately 40%.

After the Recapitalization, two Regency shareholders brought suit on behalf of all Regency shareholders challenging, among other things, the Recapitalization. The Delaware Court of Chancery found that the claims challenging the Recapitalization were derivative in nature and dismissed those claims based on the failure to make a pre-suit demand under Rule 23.1. Plaintiffs appealed.

In support of their position that plaintiffs' claims were solely derivative, defendants argued that the Recapitalization did not fall within the transactional paradigm for direct claims set forth in *In re Tri-Star Pictures, Inc.*, 634 A.2d 319 (Del. 1993) and more recently in *Gentile v. Rossette*, 906 A.2d 91 (Del. 2006), because the Recapitalization was a unitary, arm's-length transaction in which majority control of Regency was transferred from the minority shareholders to Royalty, a non-fiduciary third party. Moreover, the defendants argued, the former controlling shareholder, Ponsoldt/Statesman, received no corresponding benefit from any voting power or economic value taken from the minority shareholders. Based on the allegations in the Complaint, the Supreme Court rejected defendants' arguments and held that the Recapitalization fit within the *Tri-Star/Rossette* paradigm for direct claims (in addition to derivative claims). The Court held that, based on its actual effects, the Recapitalization was equivalent to the controlling shareholder expropriating the public's voting power and economic value and, then, selling it to a third party. The Court declined to view each step of the Recapitalization independently for purposes of making the direct/derivative determination,

explaining that, “To do so would unjustly exalt form over substance in circumstances where identical policy concerns that underlie *Tri-Star* and *Rossette* exist here.” *Gatz*, 2007 WL 1120338 at \*12.

The Court endorsed the idea that a transaction that resulted in a third party receiving the benefits of the expropriation, with the controlling shareholder being an intermediary that transfers the benefits of the expropriation to a third party in exchange for cash or other equivalent value, “is not a circumstance that can justify depriving the injured public shareholders of the right they would otherwise have to seek redress in a direct action. The difference in form [between the present situation and *Tri-Star/Rossette*], which is a product of transactional creativity, should not affect how the law views the substance of what truly occurred, or how the public shareholders’ claim for redress should be characterized.” *Id.* at \*13. In the end, the Court concluded that the key common dynamic of the situation in *Gatz* and *Tri-Star/Rossette* was that “the fiduciary exercise[d] its control over the corporate machinery to cause an expropriation of economic value and voting power from the public shareholders.” *Id.*

Corporate attorneys should take care that transactions, in any form, do not fall within the substantive policy, announced in *Tri-Star* and now confirmed in *Rossette* and *Gatz*, that majority or controlling shareholders cannot take away voting power or economic power from the other shareholders for their own benefit without meeting the requirements of Delaware law to ensure the fairness of the transaction.

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