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Court Affirms Dismissal of Stockholder Complaint as Derivative Following Merger

Posted by Noam Noked, co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Monday August 26, 2013

Editor's Note: The following post comes to us from David J. Berger, partner focusing on corporate governance at Wilson Sonsini Goodrich & Rosati, and is based on a WSGR Alert memorandum. This post is part of the Delaware law series, which is cosponsored by the Forum and Corporation Service Company; links to other posts in the series are available here.

On August 12, 2013, the U.S. Court of Appeals for the Fifth Circuit affirmed the dismissal of a lawsuit contending that alleged controlling stockholders of Ascension Orthopedics, Inc. had expropriated voting and economic control from the minority stockholders via a series of financing transactions that occurred before Ascension merged with another company. The Fifth Circuit affirmed the district court's decision that, under applicable Delaware law, the claims by the minority stockholders were derivative rather than direct, and thus were extinguished by the merger. Wilson Sonsini Goodrich & Rosati represented the former directors of Ascension in the litigation and represented Ascension in the financing and acquisition transactions.

Background

It is not uncommon for stockholders to see their ownership interests diluted when the company in which they invested seeks to raise additional funds through the issuance of new shares or new classes of stock. Under Delaware law, such dilution claims are typically viewed as derivative. This means that such claims can only be brought on behalf of the company in which those stockholders invested, and cannot be brought as direct claims by individual stockholders. Whether a claim is characterized as direct or derivative can have significant consequences if the company is sold: direct claims against former directors or officers of the company will survive a merger, whereas derivative claims, which belong to the company itself, will not.

In *Gentile v. Rossette*, 906 A.2d 91 (Del. 2006), the Delaware Supreme Court recognized a limited exception to the rule that actions challenging dilutive financings are derivative. There, the court held that where a controlling stockholder improperly expropriates economic value and voting power from minority stockholders, those minority stockholders are harmed, uniquely and individually, to the same extent that the controlling stockholder is correspondingly benefited. In such a situation, the minority stockholder may assert a direct claim.

The *Ascension* Case

In *Ascension,* the plaintiffs argued that their inequitable dilution claims fit "squarely" within the *Gentile* exception, i.e., that as a result of dilutive financing transactions purportedly undertaken at the behest of a controlling stockholder, the plaintiffs and other minority stockholders received no compensation for their stock when Ascension was ultimately sold. The plaintiffs admitted, however, that regardless of whether *other* minority stockholders were allegedly excluded from participating in the financing transactions that the plaintiffs now challenged as unfairly dilutive, the plaintiffs themselves had been invited to participate *pro rata* in those financings, but elected not to do so. Had the plaintiffs elected to participate, they would not have suffered any dilution of their equity interest in Ascension. The district court found this fact to be dispositive: the plaintiffs could not assert a direct claim "under *Gentile* and its progeny, because they have not, and cannot, allege they were excluded from any benefit: they could have participated, but chose not to." On appeal, the Fifth Circuit affirmed for the reasons stated in the district court's opinion.

Key Takeaways

The decision in *Ascension* illustrates the potential dangers of corporate financings led by insiders. Where the insider is alleged to be a controlling stockholder, the financing may give rise to a direct cause of action by minority stockholders if such otherwise qualified minority stockholders are excluded from participating in the financing. The decision also highlights the benefits of conducting a "rights offering" to allow non-controlling stockholders to participate in a financing on the same terms as a controlling stockholder.