Chicago Bar Association
Business Divorce and Complex Ownership Disputes Committee

"*Direct and Derivative Standing Under Illinois and Delaware Law*"

March 9, 2020

Thomas Kanyock
John Cerney
SCHWARTZ & KANYOCK, LLC
33 North Dearborn Street, Ste. 2330
Chicago, IL 60602
(312) 441-1040

• WHY ARE WE TALKING ABOUT DIRECT AND DERIVATIVE STANDING?

Courts face an increasingly common problem as they apply generations of older corporate law to the relatively recent but growing LLC, S-Corp and LLP forms of business. The old law is something of a square peg trying to fit into a round hole, particularly when it comes to standing issues. Policies underlying standing concepts in corporate settings generations ago do not always mesh well with the context of statutory closely held entities developed in the 1990s. The overall concepts generally still work; a shareholder suffering the same injury as other shareholders should not represent their uniform interests. On the other hand, co-owners of smaller closely held entities, often owing mutual fiduciary obligations, have more direct obligations to each other than in the past, including lost income and guaranteed company debt, leading more often to misconduct resulting in harm impacting minority equity owners out of proportion to the diminished value of individual interests in the company.

• WHY PAIR ILLINOIS AND DELAWARE LAW?

In 1988, in Weil v. NW. Indus., Inc., 168 Ill.App.3d 1, 5 (1st Dist. 1988), the Court found Illinois and Delaware law are identical regarding who may maintain derivative actions. In 2016, in Caulfield v. Packer Grp., Inc., 2016 IL App (1st) 151558, ¶33, the same Court reiterated that Illinois follows Delaware regarding standing issues. However, as explained below, in 2016, in El Paso Pipeline Partners, GP Co. LLC v. Brinckerhoff, 152 A.3d 1248 (Del. 2016), the Delaware Supreme Court may have diverged from Illinois law. Until the Delaware Supreme Court chooses to again address standing in this context, the role equity plays in Delaware when determining standing remains unclear.

• DERIVATIVE STANDING: WHO IS THE "CHAMPION"?

Equity owners may bring derivative suits on behalf of a company for wrongs against the corporation or LLC. 805 ILCS 5/7.80; 805 ILCS 180/40-1. The plaintiff must have been a shareholder when the cause of action arose or have received the shares by operation of law from

someone who held them at that time to have standing under Illinois' Business Corporations Act, 805 ILCS 5/7.80(a). Illinois' Limited Liability Company Act similarly requires standing as a current member or transferee, 805 ILCS 180/40-5.

A shareholder has no individual right of action against third persons for injuries to the corporation that harm the shareholder indirectly. In 1996, in Frank v. Hadesman & Frank, Inc., 83 F.3d 158 (7th Cir. 1996), the Court applied Illinois law and explained as follows:

> An action in which the [plaintiff] can prevail only by showing an injury or breach of duty to the corporation should be treated as a derivative action … An action in which the [plaintiff] can prevail without showing an injury or breach of duty to the corporation should be treated as a direct action …

Id. at 160, *quoting* American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* 7.01 (1992).

In 1999, in Small v. Sussman, 306 Ill.App.3d 639(1st Dist. 1999), perhaps the leading Illinois case, the Appellate Court held that a shareholder must bring an action for harm to the corporation in the corporate name. Even shareholders of small closely held corporations, who often owe direct duties to each other, cannot automatically pursue claims directly. The Small Court specifically rejected suggestions by some commentators and courts seeking to eliminate the direct/derivative distinction in such cases. Id., at 643. The company, and not the individual shareholders, must seek redress for the diminished value of the company when all shareholders are injured "*uniformly.*" Id., at 644. The Court emphasized strict focus on claimed injuries – not liability theories.

See e.g., Sterling Radio Stations v. Weinstine, 328 Ill.App.3d 58, 62 (1st Dist. 2002); Marriage of Schweihs, 272 Ill.App.3d 653, 665 (1st Dist. 1995) (usurped corporate opportunity derivative); LID Assoc. v. Dolan, 324 Ill.App.3d 1047, 1069 (1st Dist. 2001) (diminished equity value derivative); Caparos v. Morton, 364 Ill.App.3d 159, 169 (1st Dist. 2006) (no standing for unjust enrichment claim).

In 2015, in Stevens v. McGuireWoods LLP, 2015 IL 118652, the Illinois Supreme Court confirmed that Illinois still distinguishes between direct and derivative standing to ensure that the entity has a proper "champion":

> Put another way, the nominal plaintiff in a derivative action serves only as a "champion" of the corporation's claims. [Omitted]. The result is that the nominal plaintiff benefits only indirectly from a successful shareholder derivative suit …

Id. at ¶15. "The gravamen of standing is a real interest in the outcome of the controversy", id., at ¶23. The Court quoted its prior opinion in Brown v. Tenney, 125 Ill.2d 348, 357 (1988), where

it said that the issue is who is the company's true "champion" when those controlling the company fail to protect it properly. Stevens, 2015 IL 118652, ¶23.

A company should generally champion itself in order to protect itself and non-owner creditors. Caufield v. Packer Group, Inc., 2016 IL App (1st) 151558 (creditors have derivative standing when the company becomes insolvent). Shareholders not receiving direct recovery must rely only on derivative rights under statutes like the BCA and LLC Act. That generally makes sense since, when impacted uniformly, the company remains best positioned to "champion" its own interests.

- **DIRECT STANDING: WHAT IS "GRAVAMEN"?**

Illinois law nonetheless allows courts to ask *why* we impose standing obligations. "The doctrine of standing ensures that issues are raised only by parties having a real interest in the outcome of the controversy." Powell v. Dean Foods Co., 2012 IL 111714, ¶ 35; Stevens v. McGuireWoods, LLP. 2015 IL 118652, ¶23 (same). As discussed below, Delaware is less clear.

"Gravamen" is the right word. Illinois focuses on the essence of the cause of action. We do that by focusing on the relief requested, as discussed in Small. However, in some contexts, it makes less sense to apply the same formulistic approach to standing we applied in the 1950s for a shareholder wanting to sue on behalf of Standard Oil. If the corporation suffered the injury, then the claim belongs to the corporation and the shareholder must sue derivatively, even if the shareholder personally suffered. *Vice versa*, if the individual suffered a disparate or distinct injury, then the claim belongs to the individual. Cases often involve both direct and derivative claims, raising a swath of issues with which courts across the nation have struggled.

Policy concerns underlying the derivative rule support a client's right to direct redress. We hold dominant owners to more than the morals of the market place; the standard exceeds honesty alone, requiring "the punctilio of an honor the most sensitive", Meinhard v. Salmon, 164 N.E. 545, 546 (NY 1928); Perlman v. Feldman, 219 F.2d 173, 178 (2nd Cir. 1955) (awarding minority direct damages on good faith and fair dealing claim measured by the diminished value of the company and his interest).

Given the growth of small closely held entities, courts allow direct claims when the majority *targets* the minority's equity interest. Courts in Illinois, Delaware (at least in the past), and around the nation allow direct standing to prevent fiduciaries from benefitting from their misconduct. *E.g.*, 1515 North Wells, L.P. v. 1513 North Wells, LLC, 392 Ill.App.3d 863, 874 (1st Dist. 2009) (direct claim for fiduciary breach); Fischer v. Fischer, 1999 WL 1032768, at *4 (Del Ch. 1999) (allowing direct standing for targeting minority owner's continued participation); Atkinson v. Marquart, 112 Ariz. 304, 307 (1975) (disloyalty by establishing competing entity breached fiduciary duty of good faith and fair dealing for which direct action arose to prevent defendants from benefitting from their own misconduct).

To have standing to sue individually, rather than derivatively on behalf of the corporation, the plaintiff must allege a special injury, "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." Spillyards v. Abboud, 278 Ill.App.3d 663, 670–71 (1st Dist. 1996); Schlafly v. Forum, 2019 WL 77362, at *3 (E.D. Mo. 2019) (Ill. law) (discussing Spillyards).

In Small, the Court said only that the company may seek redress when all shareholders are impacted "uniformly", 306 Ill.App.3d at 643. Thus, Illinois courts look to the "gravamen" – or essence -- of the claim and permit direct standing when the misconduct impacts co-owners differently. *E.g.*, Vendo Co. v. Stoner, 58 Ill.2d 289, 310 (1974) (affirming awards for both "lost profits" and "diminution in the value of the business"; Zokoych v. Spalding, 36 Ill.App.3d 654 (1st Dist. 1976) (direct claim for fiduciary disloyalty causing diminished value, triggered guaranty and lost income); Anest v. Audio, 332 Ill.App.3d 468 (2nd Dist. 2002) (direct claim where disloyalty caused diminished value and triggered guaranty.

In Zokoych, unlike in Small, defendants' misconduct led to injuries impacting plaintiff disproportionately. A federal court applying Illinois law harmonized Zokoych and Small in Elmhurst Consulting LLC v. Gibson, 219 F.R.D. 125, 127 (N.D. Ill. 2003):

> Elmhurst's reliance on *Zokoych v. Spalding*, 36 Ill.App.3d 654, 344 N.E.2d 805 (1st Dist.1976), is misplaced. As that court held, the question is whether the "'gravamen' of the pleadings states injury to the plaintiff upon an individual claim as distinguished from an injury which indirectly affects the shareholders or affects them as a whole." 344 N.E.2d at 813. ***In that case, the plaintiff's essential injuries, in being removed as president and director, not getting back his pledged stock, not getting his salary, and leaving him as guarantor of the debt of the company allegedly driven into bankruptcy by defendants, were individual and separate from the injury to the company*** (emphasis supplied).

As discussed below, until 2016, Delaware law seemed consistent with Illinois law. In Gentile v. Rossette, 906 A.2d 91, 99-100 (Del. 2006), the Delaware Supreme Court, like the Illinois Appellate Court in Spillyards, 278 Ill.App.3d at 670–71, permitted direct standing by emphasizing dual claims relating to control and voting rights.

In Boyer v. Wilmington Materials, Inc., 754 A.2d 881, 899 (Del. Ch. 1999), a Delaware Chancery Court case, plaintiff requested direct relief including his share of the diminished value of the company. The Court *emphatically* rejected defendant's argument that plaintiff's fiduciary good faith and fair dealing claims were derivative and not direct, because defendant's point was to continue the business while excluding plaintiff's interest:

> That Boyer suffered an injury distinct from that of defendants is ***clear and requires little discussion***. Defendants' unfair actions deprived Boyer of his fair share of WMI, an injury that only he (and Cole) suffered, as defendants continued the business through DAI.

Id., at 903 (emphasis added); *also* Fischer, 1999 WL 1032768, at *4 (direct claim permitted where minority owner targeted by the majority defendants to eliminate his continued participation); Borghetti v. Syst. and Comp. Tech., 199 P.3d 907, 914-17 (Utah 2008) (Del. law) (fiduciary claim included recessionary damages to place plaintiff in the position he would have been in prior to misconduct, measured by the value of the plaintiff's interest); Kelly v. Blum, 2010 WL 629850, **13-14 (Del Ch. 2010), wherein the Court provided an in-depth analysis of whether fiduciary duties and good faith and fair dealing claims are direct or derivative in an LLC, holding both direct in the context of a majority engaging in transactions in order to enrich themselves at the target minority's expense.

The Boyer Court found it "abundantly clear" that the majority established a new entity to continue the old entity's operations, but without plaintiff's participation. In Boyer, a company in which plaintiff was a stockholder sold substantially all its assets to another company, 754 A.2d at 885. At the time of the sale, the purchaser company was owned by three of the five directors who voted to approve the transaction on behalf of the seller company. The remaining two directors had secured a contractual right to become stockholders of the purchaser company. Id. As a result of the sale, the value of the seller company as a going concern was destroyed, such that the plaintiff was effectively deprived of the value of his shares in the seller company held before the sale. Id. at 899. Plaintiff filed suit, individually and derivatively, alleging that the sale breached the directors' fiduciary duty of good faith and fair dealing, and that the principal purpose of the sale was to eliminate plaintiff and another stockholder from continued participation in the ownership and management of the seller company's assets and business. Id. at 885. The Court found that only plaintiff and one other stockholder suffered because defendants continued the seller company's business through the purchaser company. Id. at 903. The Court awarded plaintiff, individually, damages equal to the value of his shares in the seller company at the time of the sale. Id. at 905.

At least one Illinois Circuit Court has cited Boyer. In Janousek v. Slotky, 2009 CH 22216 (Cir. Ct. Cook Cty., November 29, 2016), the 60% owners of an LLC formed another entity with the identical business plan. The Court awarded the minority the destroyed value of his 40% interest in the original LLC. As in Boyer, the minority suffered disproportionately because, while the majority lost their 60% interest in the destroyed company, they benefited significantly by shearing-off plaintiff and continuing the business without him in another entity which they owned 100%, after successfully utilizing the first company's assets and opportunities.

- **WHAT ABOUT BOTH DIRECT AND DERIVATIVE STANDING**?

Illinois and other jurisdictions permit both direct and derivative claims. *E.g.*, Levy v. Markal Sales Corp., 268 Ill.App.3d 355, 376 (1st Dist. 1994) (holding that a shareholder may bring *both* direct and derivative claims when impacted differently from other shareholders); Tully v. McLean, 409 Ill.App.3d 659 (1st Dist. 2011) (awarding LLC member damages both "individually and derivatively" for fiduciary disloyalty, fashioning a remedy by accounting for plaintiff's 50% interest); Marquis Theatre Corp. v. Condado Mini Cinema, 846 F.2d 86, 92 (1st Cir. 1988) (direct payment in a derivative disloyal competition claim equal to plaintiff's *pro rata* share); Boyer, 754 A.2d at 906 (awarding derivative relief for injury to LLC, as well as direct relief for member's *pro rata* share); DRW Builders, Inc. v. Richardson, 679 N.E.2d 902, 907-09 (Ind. App. 1997) (awarding direct and derivative relief, as well as derivative expenses).

In Levy, 268 Ill.App.3d 355, the Illinois Appellate Court held that a shareholder may bring both direct and derivative claims when impacted differently from other shareholders. The Court found against defendants on a fiduciary disloyalty claim because they destroyed plaintiff's interest by establishing a competing entity -- even though the Court also found that plaintiff proved no damages different than his derivative claim, and awarded only the diminished value of plaintiff's interests, as if defendants had converted the interest.

In Pielet v. Hiffman, 407 Ill.App.3d 788 (1st Dist. 2011), minority owners brought a misappropriation claim, seeking both derivative and direct relief, asserting that defendants breached their statutory fiduciary duty to manage fairly and in good faith by diverting opportunities which caused the LLC's financial problem, for which the defendants then issued a capital call the minority owners could not meet. The Circuit Court dismissed plaintiffs' claim. The Appellate Court *reversed*, holding, at 796-97, that plaintiffs pled direct claims because defendants used the capital call process to target their interest.

- **DELAWARE LAW: CLEAR AS MUD?**

Until the 2000s, Delaware law appeared consistent with Illinois and other jurisdictions. However, courts around the country looking to Delaware standing issues have recently struggled to harmonize Delaware precedents; particularly Gentile v. Rossette, 906 A.2d 91 (Del Sup. 2006), and El Paso Pipeline GP Co., LLC v. Brinckerhoff, 152 A.3d 1248 (Del Sup. 2016). Historical perspective may help clarify.

In 1986, in Lipton v. News Int'l, Plc, 514 A.2d 1075, 1078 (Del. 1986), the Delaware Supreme Court found that a minority stockholder stated a direct claim for breach of fiduciary duty against corporate directors. The stockholder alleged that the directors manipulated the sale of stock to a friendly buyer to avoid their removal from office causing a "special injury" to a minority stockholder attempting to acquire control of the company.

In 1996, in Grimes v. Donald, 673 A.2d 1207, 1213 (Del. 1996), the Court distinguished between direct and derivative actions in the employment agreement context involving allegations that officers abdicated the board's authority. The Court, emphasizing the nature of the wrong and to whom the relief will go, concluded that the company did not suffer the alleged injury; rather, plaintiff sought a declaration invalidating the officers' agreements because they breached responsibilities owed to stockholders.

Between Lipton, in 1986, and Grimes, in 1996, confusion existed regarding whether Delaware applied the "special injury" test or focused strictly on who suffered the alleged harm and who would receive the benefit of any recovery.

In 2004, in Tooley v. Donaldson, Lufkin & Jenette, Inc., 845 A.2d 1031, 1038-39 (Del. 2004), the Court rejected the Lipton "special injury" test in favor of the Grimes test:

> Thus, two confusing propositions have encumbered our caselaw governing the direct/derivative distinction. The "special injury" concept, applied in cases such as Lipton, can be confusing in identifying the nature of the action. The same is true of the proposition that stems from Bokat—that an action cannot be direct if all stockholders are equally affected or unless the stockholder's injury is separate and distinct from that suffered by other stockholders. The proper analysis has been and should remain that stated in Grimes, Kramer and Parnes. That is, a court should look to the nature of the wrong and to whom the relief should go. The stockholder's claimed direct injury must be independent of any alleged injury to the corporation. The stockholder must demonstrate that the duty breached was owed to the stockholder and that he or she can prevail without showing an injury to the corporation.

After Tooley, in 2004, it appeared that Delaware had closed the door against most direct actions. However, in 2006, in Gentile v. Rossette, 906 A.2d 91 (Del. 2006), the Court seemed to open that door again.

Gentile merits discussion. The majority stockholder, one of only two directors, caused the company to issue stock in exchange for the debt the company owed him. The stock was issued at an extremely favorable exchange rate and in breach of the credit agreement between the company and the majority stockholder. As a result, the majority's interest in the company increased from 61% to 93%, while the minority interest decreased from 39% to 7%. The majority stockholder then negotiated a merger with the company's primary competitor whereby the company's stockholders received stock in the acquiring company in exchange for their company stock. However, the majority stockholder negotiated a separate agreement with the acquiring company whereby it agreed to purchase over 80% of his stock one year after the merger. The acquiring company filed for bankruptcy within eighteen months after the merger was complete and after the company repurchased the majority shareholder's stock. Id. at 95-96.

The minority stockholders filed a breach of fiduciary duty claim challenging the majority stockholder's debt conversion and his soliciting the purchase commitment.

The Supreme Court reversed summary judgment in favor of the majority. After recognizing that diminished value claims normally support only derivative standing, the Court, following Tooley, discussed the two separate harms resulting from the majority stockholder's action: overpayment for the debt and a significant reduction in the minority interest's value and voting power. The Court then contrasted the harm to the corporation with the separate harm to the minority:

> 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. 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. For that reason, the harm resulting from the overpayment is not confined to an equal dilution of the economic value and voting power of each of the corporation's outstanding shares. 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.

Id., at 99-100.

The Court determined that the minority had a direct claim because, after the corporate existence of the company had been extinguished by the merger, and the acquiring firm had been liquidated, "the sole relief that is presently available would benefit only the minority shareholders." Id. at 103.

The next year, in Gatz v. Ponsoldt, 925 A.3d 1265, 1279-80 (Del. 2007), the Court approved direct standing where the controlling equity owners manipulated different transactions which, read together, revealed that defendants expropriated plaintiff's economic benefits for themselves, even though, technically, plaintiff's loss appeared not to dilute his voting rights:

> The question, as we view it, is whether because these two component transactions were timed to occur simultaneously rather than sequentially, Regency's public shareholders should lose their entitlement, under *Tri–Star/ Rossette*, to seek redress in a direct action. We think not. To do so would unjustly exalt form over substance in circumstances where the identical policy concerns that underlie *Tri–Star* and *Rossette* exist here.

After Gentile in 2006, and Gatz in 2007, plaintiffs repeatedly analogized to the voting rights in Gentile, pointing to diminished personal rights resulting from mergers and acquisitions.

In 2016, in El Paso Pipeline GP Co., LLC v. Brinckerhoff, 152 A.3d 1248 (Del 2016), the Supreme Court revisited Gentile, significantly limiting opportunities to maintain direct standing. A limited partner claimed that the general partner breached the master limited partnership agreement's contractual duty of good faith, asserting injury to the partnership caused by the general partner's conflict of interest in allowing the partnership to pay too much in a dropdown transaction. The Court held the claim solely derivative rather than dual in nature; the complaint alleged injury to the limited partner only in terms of the alleged harm to partnership, resulting in reduction of the overall value. Plaintiff included no allegations separating the partnership's contractual rights from the limited partner's contractual rights, and any recovery by limited partner would be *pro rata* in proportion to ownership interest. The Court wrote:

> Under *Tooley*, whether a claim is solely derivative or may continue as a dual-natured claim "must turn solely on the following questions: (1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?" In addition, to prove that a claim is direct, a plaintiff "must demonstrate that the duty breached was owed to the stockholder and that he or she can prevail without showing an injury to the corporation." (footnotes omitted).

Id., at 1260.

Even though the limited partner's claim had the same contractual source and duty as the partnership's claim, under the second part of the Tooley test, the only relief granted would be to the partnership – and therefore the limited partner lacked standing. Unlike Gentile, the El Paso plaintiff alleged no diluted voting rights or other unique individual injury. Id., at 1260-61.

Since 2016, courts applying Delaware law have treated El Paso as arguably gutting Gentile and curtailing direct standing. See, for example, the following description from a 2019 Delaware Chancery unpublished order:

> The Delaware Supreme Court narrowly construed the *Gentile* doctrine in *El Paso Pipeline GP Co. v. Brinckerhoff*. In that case, a limited partner challenged alleged overpayments to a controller that reduced the limited partners' economic interests but not their voting rights. The Court distinguished the facts of *Gentile*, where the challenged transactions "resulted in an improper transfer of both economic *and* voting power from the minority stockholders to the controlling stockholder," and declined to apply *Gentile* on this basis. In a concurring opinion, the Chief Justice urged his colleagues to overrule *Gentile*. Consequently, "[i]n the wake of *El Paso*, [the Court of Chancery] has exercised caution in applying the *Gentile* framework, commenting in one case that ' [w]hether *Gentile* is still good law is debatable' and finding in another that '*Gentile* must be limited to its facts.'"

Daugherty v. Dondero, 2019 WL 4740089, at *3–4 (Del. Ch. 2019) (unpublished); Branzan Alternative Inv. Fund, LLLP v. Bank of New York Mellon Tr. Co., NA, 677 F. App'x 496, 498 (10th Cir. 2017) ("In our view, *El Paso* makes clear that equity and policy considerations are irrelevant to the *Tooley* test"); Klein v. H.I.G. Capital, LLC, 2018 WL 6719717, at *5–7 (Del. Ch. 2018):

> In the wake of *El Paso*, this court has exercised caution in applying the *Gentile* framework, commenting in one case that "[w]hether *Gentile* is still good law is debatable" and finding in another that "*Gentile* must be limited to its facts."

And Watkins v. Hamm, 2018 OK CIV APP 2, ¶¶ 15-22, 419 P.3d 353, 357–60 (Ok. Civ. App. 2018) (applying Delaware law):

> However, reliance on *Gentile* to find a direct claim is problematic. Delaware courts have "struggled with how to interpret *Gentile* and its potential to undercut the traditional characterization of stock dilution claims as derivative." *Carsanaro v. Bloodhound Techs., Inc.*, 65 A.3d 618, 657 (Del. Ch. 2013). "[D]ecisions in which the Delaware Supreme Court has recognized dual-natured claims have been controversial and stand in tension with other decisions that have characterized similar claims as purely derivative." *El Paso Pipeline GP Co., L.L.C. v. Brinckerhoff*, 152 A.3d 1248, 1262 (Del. 2016) (footnote *360 omitted). "*Gentile v. Rossette* is a confusing decision, which muddies the clarity of our law in an important context." *Id*. at 1265 (Strine, C.J., concurring). And, according to Chief Justice Strine:
>
> > [*Gentile*] cannot be reconciled with the strong weight of our precedent and it **ought to be overruled**, to the extent that it allows for a direct claim in the dilution context when the issuance of stock does not involve subjecting an

> entity whose voting power was held by a diversified group of public equity holders to the control of a particular interest. *Id.* at 1266.
>
> Not only has *Gentile* been the subject of confusion and criticism in the courts of Delaware, but also that case may be on the verge of being abrogated or, at least, significantly limited. [1]

(Emphasis added by the Watkins Court.)

However, despite these and other similar calls to overrule Gentile in its entirety, the Delaware Supreme Court has not done so. In October 2019, in Sheldon v. Pinto Tech. Ventures, L.P., 220 A.3d 245, 251 (Del. 2019), the Court again explained Gentile and El Paso, saying only:

> As this Court more recently recognized in *El Paso*, "some recent case law can be read as undercutting the traditional rule that dilution claims are classically derivative." 152 A.3d at 1251. We cited *Gentile* as the principal focus of that comment. *Gentile* concerned a controlling shareholder and transactions that resulted in an improper transfer of both economic value *and* voting power from the minority stockholders to the controlling stockholders. In *El Paso*, we "decline[d] the invitation to further expand the universe of claims that can be asserted 'dually' to hold here that the extraction of solely economic value from the minority by a controlling stockholder constitutes direct injury." *Id.* at 1264.

- **ARE ILLINOIS AND DELAWARE STILL THE SAME REGARDING DIRECT AND DERIVATIVE STANDING?**

It remains unclear whether Illinois and Delaware law still harmonize. In 2015, the Delaware Chancery Court, in El Paso, relied in part on the Illinois Supreme Court's opinion in Brown v. DeYoung, 167 Ill. 549 (1897), as an example of equity permitting an individual claim with a direct payment to plaintiff equal to the diminished value of plaintiff's shares, 132 A.3d 67, 124, note 73. In 2015, in Stevens, 2015 IL 118652, ¶19, the Illinois Supreme Court adamantly insisted that Brown involved a direct and not a derivative claim. However, the next year, in El Paso, the Delaware Supreme Court *overturned* its lower court's opinion.

The 2016 El Paso opinion calls into doubt the Illinois Appellate Court's statements in Weil and Caufield that Illinois and Delaware courts treat direct and derivative standing the same. The Delaware Supreme Court disagreed with its Chancery Court in El Paso whether equitable principles apply, for which the Chancery Court relied on the Illinois Brown decision – a case the Illinois Supreme Court approved of in Stevens in 2015. Thus, the Delaware Supreme Court may

[1] Courts reviewing El Paso have tended to minimize that Justice Shrine wrote a *concurrence* and *not* the Court's opinion.

not agree with the Illinois Courts' reasoning in Brown and Levy, both permitting direct standing despite awarding only diminished value. Nor would the Delaware Court likely agree with the Tully v. McLean, 409 Ill.App.3d 659 (1st Dist. 2011), in which the Illinois Appellate Court affirmed awarding an LLC member damages both "individually and derivatively" for fiduciary disloyalty by fashioning a remedy ordering direct payment for plaintiff's 50% interest. Put another way, we doubt whether Brown, Levy and Tully would have passed Delaware's Tooley/Grimes test.

On the other hand, the Delaware Supreme Court may still agree with its Chancery Court's conclusion in Boyer that, when the majority obviously targets the minority's interest and otherwise benefits from the misconduct, it is "clear and requires little discussion" that a minority equity owner has direct standing when suffering wholly out of proportion to the other owners, 754 A.2d at 885. The "*gravamen*" of the harm suffered in Boyer and Zokoych was uniquely harmful to those plaintiffs; the essential impact did *not* consist only of the same *pro rata* diminished value suffered by all owners. The Boyer and Zokoych plaintiffs had significant and unique interests in the outcome of their claims also rendering them proper champions of their companies. Contrast these cases with the contexts in Gentile and El Paso, involving diluted stock value claims.

- **TWO COMMON FIGHT ISSUES**

Delaware and Illinois courts focus on whether the plaintiff equity holder has injuries distinct from the entity's; thus, the more facts showing individual injuries, the more likely a court permits direct standing. A lost income claim fits that bill. While a little trickier, so do claims for triggered guaranteed debt. These issues arise regularly in the standing context.

  - **Lost income claims?**

Oppression often involves squeezing the minority out of any benefits to maintaining ownership, while also freezing the minority into the fiduciary duty of loyalty prohibiting the minority from finding another job:

> Quite commonly when a participant invests in a close corporation she expects to work in the business on a full-time basis. She may put practically everything she owns into the business and expect to support herself from the salary she receives as a key employee of the company. Whenever a shareholder is deprived of employment by the corporation (as she frequently is in these squeeze plays), she may be in effect deprived of her principal means of livelihood.

O'Neal and Thompson, *1 Oppression of Min. Shareholders and LLC Members*, §1:3.

Classic oppression often leaves the minority no benefit to the membership, no income, no distributions, and no equity value. Bonavita v. Carbo, 692 A.2d 119, 127 (N.J. Super. 1996) (majority must leave minority with reasonable expectation of the possibility of a return on investment); Rexford Rand Corp. v. Ancel, 58 F.3d 1215, 1221 (7th Cir. 1995) (freeze out victim may not compete).

Looked at differently, a lost income claim in the oppression context is ***not*** a breach of employment suit; rather, it arises from plaintiff's rights as an equity owner. The majority of Courts around the nation, including in "*at will*" jurisdictions, consider employment termination when it impacts the minority's reasonable expectation to actively participate and earn a living. Selmark Assoc. Ltd. v. Ehrlich, 5 N.E.3d 923, 942-43 (Mass. Sup. 2014) (allowing lost income claim); Matter of Wiedy's, 487 N.Y.S. 2d 901 (3rd Dep't 1985) (direct relief where expectation of active participation). Haley v. Talcott, 864 A.2d 86, 94 (Del. Ch. 2004) ("*Haley never agreed to be a passive investor in the LLC*"); *also* O'Neal and Thompson, *1 Oppression of Min. Shareholders and LLC Members*, §6:5: "Excluding minority owners from company employment and eliminating them as a member or manager".

In Bluewater Logistics., LLC v. Williford, 55 So.3d 148, 152 (Miss. 2011), three LLC members, owning 75%, fired the minority member. Counsel for defendants said: "They fired him and they don't want him back … The 75% can stop his salary. They can stop his benefits. They can do anything they want to do." The majority also changed the office locks and told plaintiff to cease and desist performing any company business. They originally asserted a right under the operating agreement to buy him out, but later withdrew that offer while affirming employment termination. The Mississippi Supreme Court affirmed the chancellor's conclusion that equity prohibited the majority from preventing plaintiff from participating in company business while insisting that he remains a member frozen into his fiduciary duty of loyalty.

The majority of jurisdictions allow courts, in context, to consider lost employment claims in the minority oppression context. Delaware (and Texas) is an exception. In Riblet Prod. Corp. v. Nagy, 683 A.2d 37, 40 (Del. 1996), the Delaware Supreme Court refused to permit the minority to proceed with an employment claim in light of an existing employment contract. Courts interpreting Riblet have assumed the Court meant to disallow all lost income claims in the minority oppression context.

In McLaughlin v. Schenk, 220 P.3d 146, 157 (Utah 2009), the Utah Supreme Court aligned itself with the "majority" of jurisdictions, expressly refusing to follow Delaware's minority position automatically disallowing employment claims in the minority oppression context. The McLaughlin Court provided the following more balanced guidance:

> Not every discharge of an at-will employee of a close corporation who happens to own stock in the corporation gives rise to a successful breach of fiduciary duty claim." (Omitted) Instead, the court must consider the formal policies and

> practices of the close corporation, and how these policies and practices are interpreted by and impact all shareholders to determine whether or not a shareholder's reasonable expectations were thwarted. As the North Dakota Supreme Court has explained, when considering an allegation of oppressive conduct, a court should review
>
>> what the majority shareholders knew, or should have known, to be the petitioner's expectations in entering the particular enterprise. Majority conduct should not be deemed oppressive simply because the petitioner's subjective hopes and desires in joining the venture are not fulfilled. Disappointment alone should not necessarily be equated with oppression.
>
> Balvik v. Sylvester, 411 N.W.2d 383, 387 (N.D.1987) (*quoting* Matter of Kemp & Beatley, Inc., 64 N.Y.2d 63, 484 N.Y.S.2d 799, 473 N.E.2d 1173, 1179 (1984)).

Also Merola v. Exergen Corp., 668 N.E.2d 351, 354–55 (Mass. 1996) (distinguishing Selmark where the minority equity owner ownership did not generate a reasonable employment expectation). We found no published Illinois opinion discussing Selmark, Bluewater, or similar cases.[2]

However, in Minor v. Albright, 2001 WL 1516729, at *3 (N.D. Ill. 2001), the Court, when applying Illinois law, distinguished Riblet because the *Minor* plaintiff alleged misconduct resulting in more than just lost employment income.

Also, in June 2019, the Illinois Appellate Court issued an unpublished Rule 23 order approving a lost income claim. In Caufield v. Packer Engineering, Inc., 2019 IL App (2d) 170740-U, the trial court awarded $250,000 in damages in a shareholder/officer's oppression suit. Defendants appealed arguing error because the trial court's misconduct findings involved only plaintiff's employment capacity, and not his ability to exercise shareholder rights. The Court noted that the plain language of Illinois' BCA §12.56(a)(3), 805 ILCS 5/12.56(a)(3), provides that shareholder oppression occurs where "those in control of the corporation have acted . . . in a manner that is illegal, oppressive, or fraudulent with respect to the petitioning shareholder whether in his or her capacity as a shareholder, director, or officer", id., at ¶60. Thus, the Court reasoned, if defendants acted oppressively against plaintiff in his capacity as an officer (the president), *i.e.*, in his capacity as an employee, then he properly asserted a shareholder oppression claim.

If Illinois aligns itself with the overwhelming majority of courts allowing lost income claims if, in context, the minority equity owner had a reasonable expectation of employment,

---

[2]The Zokoych Court awarded plaintiff lost wages. However, the Court provided no explanation, and it remains unclear whether the award was for past or future wages, 36 Ill.App.3d at 670-71.

then that would serve as another example of Illinois diverging from Delaware – because a lost income claim necessarily provides unique direct standing.

- **What about triggered guaranteed debt?**

Courts have trouble analyzing direct standing in the common scenario where the minority equity owner also guaranteed company debt. When defendants tank a company, it often causes the company's lender to trigger all personal guaranties. *E.g.*, Chase v. Turner, 560 So. 2d 1317, 1319 (Fla. App. 1990) (defendants failed to share company profits, while failing to pay company debt, resulting in a judgment against plaintiff as personal guarantor). This can be a powerful oppression tactic when the controlling owners appropriate the economic value of the entity for their own uses – the economic impact then falls disparately more on the oppressed equity owner.

Some courts have held that, because establishing liability on a personal guaranty resulting from the primary debtor company's default usually requires first showing injury to the company, such claims are derivative in nature and a guarantor equity owner lacks standing. That approach seems highly formulaic. Thus, even courts holding that a shareholder's claim on a guaranty of defaulted company debt may be derivative, note that the issue may depend on whether the context involves a closely held company, particularly where defendants owed duties to plaintiffs in addition to those owed to the company. *See* Hengel, Inc. v. Hot 'N Now, Inc., 825 F.Supp. 1311, 1319 (N.D. Ill. 1993) *(citing* Zokoych in personal guaranty case); Allen & Brock Const. Co., Inc. v. Ferrara, 540 S.E.2d 761, 766-77 (N.C. App. 2000) (Del. law) (direct claim for diminished value and personal guaranty where targeting minority's ownership interest); Haley, 864 A.2d at 94 and 98 (discussing the interplay and impact of terminated employment and personal guaranty on minority's dissolution rights and buy-out); Elmhurst Consulting LLC v. Gibson, 219 FRD 125, 127 (N.D. Ill 2003) (Ill law) (distinguishing Zokoych because Zokoych involved lost income and guaranteed company debt).

See also Janousek v. Slotky, 2009 CH 22216 (Cir. Ct. Cook Cty., November 29, 2016), discussed above, wherein the 60% majority owners of an LLC formed another entity with the identical business plan. Plaintiff owned a minority 40% interest. All owners had personal guaranties triggered by the LLC's lenders, but defendants were content to enjoy the benefits of switching from a 60% interest in a $34+ million dollar company to a 100% interest in a company formed by using the first company's assets and opportunities. Under the circumstances, defendants allowed the first company default on its debt. The Court could consider plaintiff's triggered guaranty in determining that the gravamen of the claim was a targeted attempt to simply continue the business without plaintiff in another LLC.