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IN THE SUPREME COURT OF THE STATE OF DELAWARE

NAF HOLDINGS, LLC, Plaintiff/Counter-Defendant, Appellant, v. LI & FUNG (TRADING) LIMITED, Defendant/Counter-Claimant, Appellee.	:	No.: 641, 2014 Certification of Question of Law from the United States Court of Appeals for the Second Circuit in Docket No. 13-830-cv.

OPENING BRIEF OF PLAINTIFF/COUNTER-DEFENDANT, APPELLANT NAF HOLDINGS, LLC

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NATURE OF PROCEEDINGS

This action arises from the certification by the United States Court of Appeals for the Second Circuit to this Court of one question of law, arising in connection with a failed merger transaction. Plaintiff-Appellant NAF Holdings, LLC's ("NAF") sought to acquire Hampshire Group, Limited ("Hampshire") and created two wholly-owned subsidiaries to complete the merger transaction. The lynchpin to the transaction was the agreement ("Contract") between NAF and a Hong Kong company, Defendant-Appellee Li & Fung (Trading) Limited ("Trading") for Trading to act as sourcing agent. After Trading breached its Contract with NAF, the merger transaction failed. Thereafter, NAF brought an action against Trading for breach of the Contract (to which NAF was a party, and to which NAF's subsidiaries were not). The District Court dismissed the case finding that NAF's claims were derivative and could not be maintained as a direct action.

On November 19, 2014, the Second Circuit, pursuant to Supreme Court Rule 41, asked this Court to address whether, under Delaware law, NAF may assert a direct claim for breach of contract against Trading, notwithstanding that "the third-party beneficiary of the contract is a corporation in which the plaintiff-promisee owns stock; and . . . the plaintiff-promisee's loss derives indirectly from the loss suffered by the third-party beneficiary corporation." NAF Holdings, LLC v. Li &

Fung (Trading) Ltd., 772 F.3d 740, 750 (2d Cir. 2014) ("NAF II"). The Second Circuit's certified question to this Court arose out of its expressed concern that:

> **[T]his is not a typical derivative suit, and [] the normal concerns applicable to shareholder derivative suits—and the normal procedures required for bringing them—don't seem very applicable in this situation.** Id. at 751 (Lynch, C.J., concurring) (emphasis added).

Indeed, the foregoing statement does not merely express the positions of both the majority and concurring opinions in NAF II, but also succinctly summarizes the basic premise that the policies underlying shareholder derivative litigation can only be effectuated if and when applied to suitable cases, consisting of appropriate facts. This (like other cases in which a parent company is the contracting party) is not such a case.

Unlike the "typical" shareholder derivative action described by the Second Circuit – routinely involving allegations of a breach of a fiduciary duty by corporate insiders – this matter finds its genesis in NAF's claim that Trading breached obligations owed to NAF under the Contract to which Trading and NAF were the parties. Applying *dicta* from Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031 (Del. 2004), the District Court dismissed NAF's breach of contract claim, ruling that any injury arising therefrom solely belonged to NAF's subsequently-created wholly-owned subsidiaries (collectively, the "NAF Subsidiaries"). NAF Holdings, LLC v. Li & Fung (Trading) Ltd., 2013 WL

489020, at *1, *10 (S.D.N.Y. Feb. 8, 2013) ("NAF I"). However, the District Court further expressed its opinion that institution of a derivative action would be foreclosed, as the NAF Subsidiaries previously entered into a binding settlement agreement in which they waived certain rights to sue Trading, thereby leaving NAF bereft of a remedy to assert a breach of contract claim to enforce a contract to which NAF itself was the contracting party. Id.

By imposing a shareholder derivative action upon NAF's direct breach of contract claim, the District Court expanded the rubric of this type of action beyond the bounds for which it is both intended to operate, and where its underlying policies can be effectively achieved. The District Court based its ruling squarely upon its perceived inability to circumvent certain language articulated by this Court in Tooley. However, in so ruling, the District Court ignored the independent contractual duty Trading owed directly to NAF, and further disregarded prior jurisprudence recognizing that shareholder derivative actions are inapplicable to cases such as this one where the policies underlying derivative actions cannot be effectuated.

On November 25, 2014, this Court entered an order, attached hereto as Exhibit A, accepting certification.

SUMMARY OF ARGUMENT

1. Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031 (Del. 2004) is inapplicable to the facts presented in this case, and therefore NAF is not barred from asserting a direct claim against Trading for breaching the parties' contract, even though NAF's asserted damages may have been derived indirectly through diminution of value of its shares in its wholly-owned subsidiary. Tooley – which concerned a corporate insider's alleged breach of a fiduciary duty – did not consider the facts involved in or analogous to this case, and is therefore inapposite. Imposition of the requirement of instituting a derivative shareholder action to the facts presented in this case would undermine the rationales underlying derivative actions, conflict with established principles of contract law and would yield anomalous results that serve to undermine the purposes of derivative litigation.

STATEMENT OF FACTS

A. The Parties

NAF is a Delaware limited liability corporation, wholly owned by its managing principal, Efrem Gerszberg ("Gerszberg"). NAF II at 741.

Trading is a Hong Kong Company. NAF I at *1.

B. Factual Background

On December 15, 2008, NAF and Trading entered into the Contract, whereby Trading committed to serve as sourcing agent for Hampshire once NAF completed its contemplated acquisition and merger of Hampshire (the "Merger"). NAF II at 741.

After entering into the Contract, NAF decided to effectuate the Merger through two newly created subsidiaries, NAF Holdings II LLC ("NAF Holdings"), a wholly-owned subsidiary of NAF, and NAF Acquisition Corp. ("Acquisition"), a wholly-owned subsidiary of NAF Holdings (collectively, "the NAF Subsidiaries"). Id. at 741-742. The NAF Subsidiaries then entered into a merger agreement with Hampshire (the "Merger Agreement"), to be consummated upon the successful acquisition by the NAF Subsidiaries of Hampshire's stock through a tender offer. Id. at 742. Thereafter, Trading repudiated and refused to perform its contractual obligation to NAF to serve as Hampshire's sourcing agent. Id. Trading's repudiation prevented the NAF Subsidiaries from obtaining the credit they required

to acquire the Hampshire shares and caused NAF losses in excess of $30 million. Id.

After the termination of the Merger Agreement, Gerszberg and the NAF Subsidiaries, but not NAF, entered into a settlement agreement with Hampshire ("Settlement Agreement"). Id. The Settlement Agreement prohibited the NAF Subsidiaries and Gerszberg, but not NAF,[1] from instituting further suit to recover damages sustained as a result of "Transaction Agreements" or "the Transaction" (as such terms were specifically defined in the Settlement Agreement). Id.[2] In all events, the Settlement Agreement and the effect the Settlement Agreement may have on the parties, the NAF Subsidiaries and/or others are completely irrelevant to the issues now before this Court as the limited question certified for decision by this Court relates solely to whether NAF's claims are direct or derivative in nature.[3]

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[1] As the Second Circuit adeptly pointed out, prior to the entry of the Settlement Agreement, NAF and others drafted a complaint against Hampshire alleging numerous claims of wrongdoing. NAF II at 741. Ultimately, NAF was not a party to the Settlement Agreement. Id. Indeed, this fact alone confirms that Hampshire was aware of NAF's claims but knowingly sought a covenant not to sue only from the NAF Subsidiaries, and even then only on a narrowly defined basis.

[2] The Contract is not part of "the Transaction" or one of the "Transaction Documents" as defined by the Contract. See NAF I at *3 - *4.

[3] While not relevant to this proceeding, we strenuously disagree with the Trial Court's *sua sponte* finding, not based on the facts in the record, that the covenant not to sue in the Settlement Agreement would bar a derivative action. NAF I at *10. Among other reasons, (a) Trading never raised this as an affirmative defense (or at any later time in the litigation) and the defense was therefore waived; (b) Trading was not a party to the Settlement Agreement and lacks standing or the right to assert any right, remedies or defenses thereunder; (c) the parties never briefed the myriad factual issues surrounding the covenant not to sue and its application (including without limitation as it relates to the meaning of the capitalized terms "Transaction

C. Procedural History

a. The District Court Dismisses NAF's Breach Of Contract Claim

On July 29, 2010, NAF instituted the instant action, asserting a claim against Trading for breach of the Contract to which NAF and Trading were the contracting parties. NAF I at *4. On August 15, 2012, Trading moved for summary judgment. Id. On February 8, 2013, the District Court, relying on *dicta* in Tooley, 845 A.2d at 1035, 1039, entered an Order granting Trading's motion for summary judgment finding that, despite the fact that NAF entered into the Contract with Trading, NAF's claims against Trading could not be maintained as a direct suit, but only as a derivative action in the name of the NAF Subsidiaries. NAF II at 743.

On March 7, 2013, NAF filed a timely notice of appeal. Id.

b. The Second Circuit Certifies For Decision By This Court One Question Of Law

As set forth below, the Second Circuit rejected the District Court's reliance on Tooley finding that "the claims asserted in Tooley and the cases that have applied its rule are significantly different from the claims made here, and the differences appear to us to justify a different conclusion." NAF II at 741. The rejection was based on textual concerns arising out of Tooley, 845 A.2d at 749, the

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Documents" and "Transaction" as used therein and/or the intent and meaning of the language more generally); (d) the NAF Subsidiaries are not parties to this action; and (e) NAF is not a party to the Settlement Agreement and/or purported covenant not to sue so any discussion of this point by the District Court necessarily was *dicta*.

fact that Tooley – as well as both previous and subsequent case law – is factually distinguishable from the facts at issue herein, that its application here would undermine the rationales underlying shareholder derivative actions, id. at 745-746, that this case does not concern an ordinary breach of fiduciary duty claim, but concerns an independent duty of a third-party, id. at 746-749, that application of Tooley to these facts conflicts with well-established contract principles, id. at 747-748, and that application of Tooley to these facts yields anomalous application of derivative action requirements. Id. at 748-749. Though he expressed some contrary considerations, Judge Lynch ultimately concurred with the majority that Tooley's "broad statement" is not easily applied to the facts at issue in this case, which are "distinguishable" from those considered in Tooley. Id. at 751-752 (Lynch, C.J., concurring).[4]

On November 19, 2014, the Second Circuit, pursuant to Rule 41 of the Supreme Court of the State of Delaware, certified a question of law to this Court. NAF II at 750.

[4] Pointedly, the Second Circuit noted that questions regarding what damages NAF may be able to recover should this Court permit it to assert a direct breach of contract claim against Trading are entirely inapposite to the legal issue to be decided herein. See NAF II at 746, n.5 (emphasis added) ("We can only speculate as to why NAF was excluded from the Settlement Agreement; it may be that the parties made an error or that this exclusion was specifically negotiated to allow NAF to bring this very suit. Regardless, the fact of the Settlement Agreement, which excludes both parties to this suit, **seems irrelevant to the specific question of whether Delaware law would hold that NAF's claim against Trading is direct or derivative**").

ARGUMENT

A. Question Presented

Pursuant to the Second Circuit in NAF II at 750: "Where the plaintiff has secured a contractual commitment of its contracting counterparty, the defendant, to render a benefit to a third party, and the counterparty breaches that commitment, may the promisee-plaintiff bring a direct suit against the promisor for damages suffered by the plaintiff resulting from the promisor's breach, notwithstanding that (1) the third-party beneficiary of the contract is a corporation in which the plaintiff-promisee owns stock; and (ii) the plaintiff-promisee's loss derives indirectly from the loss suffered by the third-party beneficiary corporation; or must the court grant the motion of the promisor-defendant to dismiss the suit on the theory that the plaintiff may enforce the contract only through a derivative action brought in the name of the third-party beneficiary corporation?"

B. Scope Of Review

When addressing a certified question of law, "the normal standards of review do not apply." State v. Anderson, 697 A.2d 379, 382 (Del. 1997). "This Court must review the certified questions in the context in which they arise." Id. The question presented arises as a question of law certified to this Court by the Second Circuit. This Court reviews such questions of law *de novo*. Outten v. State, 720 A.2d 547, 551 (Del. 1998).

C. Merits Of Argument

I. NAF IS NOT REQUIRED TO INSTITUTE A SHAREHOLDER DERIVATIVE ACTION IN ORDER TO BRING ITS BREACH OF CONTRACT CLAIM AGAINST TRADING

As two commentators recently noted, the Second Circuit "was understandably reluctant to apply the usual direct vs. derivative analysis to bar a contract claim" in this case.[5] The reason for this reluctance was due to the fact that application of overly broad categorical language in Tooley, drafted without fact patterns such as this one in mind, will have unintended and negative consequences if applied categorically. It is just this situation that the Second Circuit designated as "unusually troublesome." NAF II at 750.[6]

As set forth below, such results were not intended to be generated by overly-broad applications of Tooley. Additionally, imposing the requirement to institute a shareholder derivative action on factually distinguishable cases fails to effectuate the policies underlying derivative actions, actively impedes them, intrudes upon settled judicial doctrines in other, related areas of law and produces other

[5] See Sarah S. Gold and Richard L. Spinogatti, *Applying Delaware's Direct vs. Derivative Analysis* (N.Y.L.J. Dec. 10, 2014), attached hereto as Exhibit B.

[6] See, e.g., 12B Fletcher Cyc. Corp. § 5911 ("General rules as to whether individual or derivative—In general") (Sep. 2014) (footnote omitted) (Noting that "[w]hile there usually is little difficulty in determining whether a cause of action on behalf of a shareholder is individual or derivative, there are border-line cases that may be hard to classify"); Grill v. Aversa, 2014 WL 4672461, at *7 (M.D. Pa. Sep. 18, 2014) ("While this distinction between direct and derivative actions is straightforward in its articulation, it can be more complex in its application since many actions by the majority shareholders in a corporation may result both in direct harm to an individual shareholder, and lead to a broader injury to the corporation itself").

anomalous results. These consequences, taken as a whole, yield one unequivocal conclusion – that the District Court erred by imposing the requirement to institute a shareholder derivative action on NAF's direct breach of contract claim.

Significantly, treating NAF's cause of action for breach of contract as a direct claim is also harmonious with prior jurisprudence limiting application of shareholder derivative actions.

For all these reasons, this Court should rule that Delaware law permits NAF to assert a direct breach of contract claim against Trading.

i. *Tooley* Is Inapplicable To This Case As NAF's Breach Of Contract Claim Rests On An Independent Duty Owed To It Directly, Which Precludes The Policies Underlying Shareholder Derivative Actions From Being Effectuated In This Case

In Tooley, this Court both reviewed and elucidated its prior jurisprudence regarding the standard to be applied to determining whether a claim is direct or derivative, concluding that:

> The proper analysis [to determine whether a claim is direct or derivative is that]… 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 [1] that the duty breached was owed to the stockholder and [2] that he or she can prevail without showing an injury to the corporation. Tooley, 845 A.2d at 1039.

Here, Tooley's "broad pronouncement" should not be applicable to this matter at all. NAF II at 745.

Pointedly, as both the majority and concurring opinions in the Second Circuit noted, the portion of the Tooley opinion at issue is technically dicta. See, e.g., NAF II at 749, n.7 (Questioning whether the unique facts of this case require "literal adherence to the formulation of the Tooley dictum"); id. at 751 (Lynch, C.J., concurring) (Noting that "Tooley is technically dictum"). As dicta, it follows that the language in Tooley is simply illustrative and non-precedential, and not applicable to the facts of our case.

Reviewing both Tooley and this Court's prior decisions, the Second Circuit conducted an analysis of Tooley's applicability, lucidly explaining the rationales for excluding this case from Tooley's ambit. First, it explained that the instant matter is factually distinguishable from Tooley:

> There is, however, a difference between this case on the one hand and, on the other hand, *Tooley* and all the precedents reviewed by *Tooley* in its discussion… The claim in *Tooley* was based on the defendants' alleged violation of fiduciary duties arising by law from the defendants' status in the corporate structure. These are the most conventional and familiar sorts of claims involved in litigation by shareholders of the type that raises troublesome questions whether the suit is properly characterized as direct or derivative…
>
> **NAF's claim is different in this respect. Its claim is not predicated on a breach of a duty that the law imposes by reason of the defendant's affiliation with the corporation. NAF's claim is based on a contractual duty owed directly to it by the defendant…**

> **Because NAF's claim arises from a contractual commitment Trading made directly to it, this suit raises considerations that were not present in *Tooley* or the cases that have applied it.**

NAF II at 745 (footnotes omitted) (emphasis added).[7] Next, the Second Circuit set forth the significance of the foregoing factual distinction, explaining that:

> **The defendant's direct contractual obligation to the plaintiff has a significant bearing on the purpose of the obligation of a shareholder to proceed in appropriate cases by derivative action…**
>
> The purpose of the rule that requires that certain stockholder suits be brought only by means of a derivative action is to protect the separate integrity of the corporation, distinct from its shareholders—allowing the corporation, within the bounds of the business judgment rule, to make decisions for itself rather than have them dictated by shareholders…
>
> **Categorical extension of the aspect of the *Tooley* rule that prohibits the stockholder from proceeding by direct suit unless the stockholder "can prevail without showing an injury to the corporation" to cases where the stockholder is enforcing a personal contractual right would in many circumstances impair, rather than protect, the corporation's decision-making autonomy.**

Id. at 745-746 (emphasis added). In other words, in circumstances such as those presented in this case – where the cause of action being asserted is not premised on a breach of fiduciary duty by a corporate insider, but instead is based on a third-party's breach of an independent duty – imposing the requirement to institute a

[7] The Second Circuit also noted that "each of the subsequent cases in which the Delaware Supreme Court has cited *Tooley* has also involved similar claims of breach of fiduciary (or like) duties that are implied by law arising out of the defendant's relationship to the corporation." NAF II at 745 (footnote omitted).

shareholder derivative action can easily result in impeding the underlying rationale of ensuring an entity's ability to make independent decisions in its own best interest.[8]

The Second Circuit presented one such example of the deleterious effect of binding corporate managers, and precluding the corporation from obtaining highly desirable and beneficial opportunities. Suppose, it posited, that one of the corporation's minority shareholders is desirous to secure contractual commitments from a third-party that would assist the corporation achieve its stated objectives. Id. at 746-747. However, recognizing the difficulties inherent in a shareholder proceeding via derivative action, the minority shareholder would be unwilling to secure the contractual commitment unless the corporation agrees that he may institute a direct suit to enforce the contract made to secure the beneficial commitment. Id. In such a situation:

> **The corporation may be highly desirous of agreeing to this condition so as to obtain the benefits. However, the *Tooley* rule would prevent the corporation from delivering an enforceable contract to allow the suit, so as to secure this benefit for itself.** As the objection to the shareholder's bringing the suit directly, as opposed to by derivative procedure, may be raised by the defendant, the corporation's contractual consent would serve no purpose. The

[8] While there are additional policies underlying shareholder derivative actions, "the role of management in overseeing the corporation's affairs [is] perhaps the most compelling justification that can be found for distinguishing between a direct and derivative action." See 3 Treatise on the Law of Corporations § 15:2 (3d) ("Nature and basis of derivative action") (Dec. 2014). Additionally, other rationales underlying shareholder litigation – for example, prevention of multiple suits being filed by multiple shareholders – are also inapplicable to these facts.

> shareholder, in bringing the suit, would be unable to satisfy the requirement of *Tooley* of demonstrating "that he or she can prevail without showing injury to the corporation." … **Barring the shareholder from asserting a claim arising from its own personal contract with the defendant seems to us difficult to justify.**

Id. (footnotes omitted) (emphasis added).[9] See also Dinuro Investments, LLC v. Camacho, 141 So. 3d 731, 738 (Fl. Ct. App. 2014) (Noting that "[t]he "duty owed" approach allows for the greatest freedom of contract, as parties can actively decide whether and when to allow direct suit between members for various categories of conduct"). That such concerns can easily arise only underscores that cases concerning the breach of an independent duty by a third-party in general – and the facts of this case in particular – do not neatly fall within the established direct-derivative dichotomy.

The Second Circuit found further support for its "doubts whether the *Tooley* Court intended to encompass cases of this nature" from the fact that Tooley itself "was particularly complimentary" of Agostino v. Hicks, 2004 WL 443987 (Del. Ch. Mar. 11, 2004), which suggests a distinction between applying direct-derivative analysis in breach of fiduciary duty cases from other types of cases. Id. at 749. It noted that Tooley cited Agostino for the proposition that in conducting the direct-derivative analysis, "in the context of fiduciary duty claims, the focus

[9] Additionally, as noted by the Second Circuit, in such a scenario there may often be independent reasons why the corporation itself will not assert its own rights as a third-party beneficiary, thereby further supporting the conclusion that imposition of a shareholder derivative requirement will impede the process of independent corporate decision-making. See NAF II at 746, n.6.

should be on the nature of the injury. *In other contexts, the focus upon to whom the relevant duty is owed will allow the segregation of derivative claims.*" Id. citing Tooley, 845 A.2d at 1036, n.9 citing Agostino 2004 WL 443987, at *7, n.54 (emphasis in original). Based on the foregoing, the Second Circuit concluded that:

> [T]he reasoning of *Agostino*, which was praised in *Tooley*, suggests that, while fiduciary duty claims call for focus on the nature of the injury, **other sorts of claims, such as suits to enforce contractual commitments, should be analyzed differently; the focus should be on whether the duty sought to be enforced was owed by the defendant directly to the plaintiff-shareholder.**

Id. (emphasis added).

In addition to the foregoing, this conclusion is itself supported by the fact that while this case does not neatly fit into the direct-derivative dichotomy, it easily corresponds to a line of precedent, which has routinely recognized that while:

> In general, a shareholder has no individual cause of action for injuries to his corporation… There are two major, often overlapping, exceptions to the general rule: (1) where the shareholder suffered an injury separate and distinct from that suffered by other shareholders, and **(2) where there is a special duty, such as a contractual duty, between the alleged wrongdoer and the shareholder.**

Hikita v. Nichiro Gyogyo Kaisha, Ltd., 713 P.2d 1197, 1199 (Alaska 1986) (emphasis added). See also, e.g., Delgadillo v. White, 2008 WL 4095494, at *3 (Ariz. Ct. App. Apr. 22, 2008); Chambrella v. Rutledge, 740 P.2d 1008, 1013-104 (Haw. 1987) (emphasis added) ("If the injury is one to the plaintiff as a shareholder and to him individually, and not to the corporation, **as where the action is** based

on a contract to which he is a party, or on a right belonging severally to him, or on a fraud affecting him directly, it is an individual action"); Grill, 2014 WL 4672461, at *7 (internal citation omitted) (emphasis added) ("If the injury is one to the plaintiff as a shareholder as an individual, and not to the corporation, **for example, where the action is based on a contract to which the shareholder is a party**, or on a right belonging to the shareholder, or on a fraud affecting the shareholder directly, or where there is a duty owed to the individual independent of the person's status as a shareholder, it is an individual action"); Krier v. Vilione, 766 N.W.2d 517, 527 n.13 (Wis. 2009); 12B Fletcher Cyc. Corp. § 5911 ("General rules as to whether individual or derivative—In general") (Sep. 2014) (footnotes omitted) (emphasis added) ("If the injury is one to the plaintiff as a shareholder as an individual, and not to the corporation, **for example, where the action is based on a contract to which the shareholder is a party**, or on a right belonging severally to the shareholder, or on a fraud affecting the shareholder directly, or where there is a duty owed to the individual independent of the person's status as a shareholder, it is an individual action"); 12B Fletcher Cyc. Corp. § 5913 ("General rules as to whether individual or derivative—Depreciation of value of stock) (Sep. 2014) (footnote omitted) (Same) ("Where the wrongful acts are not only wrongs against the corporation but are also violations by the wrongdoer of a duty arising from contract or otherwise and owing directly to the shareholders, individual

shareholders can sue in their own right"); Principles of Corp. Governance § 7.01 ("Direct and Derivative Actions Distinguished"), cmt. "c" (1994, updated Oct. 2014) (citations omitted) (emphasis added)(Noting that "[d]ecisions in both Delaware and New York have held that an action may be treated as direct, even though the principal injury is to the corporation, if there is "also special injury to the individual stockholder." … Originally, these cases involved circumstances in which there was a special dual relationship between plaintiff and defendant, **such as a contractual relationship**, or in which the latter acted with deliberate intent to harm the former").

Indeed, independent of Tooley, courts have ruled that a parent company may assert even a direct claim for *breach of fiduciary duty* against one of its directors, despite the fact that the alleged damages derive from diminution of value in the parent's shares of a wholly-owned subsidiary. In Case Financial, Inc. v. Alden, 2009 WL 2581873, at *1-*3 (Del. Ch. Aug. 21, 2009), a parent company sued its former director and CEO for breach of fiduciary duty arising out of loans made exclusively by its wholly-owned subsidiary. Relying on Tooley, the former director argued that the parent's claims could only be asserted derivatively. Id. at *5 and n.32. The Court of Chancery rejected this argument, and allowed the parent to sue the former director for breach of the fiduciary duties he owed directly to the parent. Id. at *6-*7. The Court of Chancery explained that:

> Ultimately, [the former director], as a director of [the parent], had a duty not to intentionally or knowingly participate in conduct that would injure [it]. Because [the former director] owed this duty to [the parent] directly, [the parent's] ability to pursue a suit against [the former director] directly would not depend, in this sense, on whether the entirety of the damage was sustained directly by [the parent] or derivatively through [the subsidiary]. **To the contrary, if [the former director] was substantially certain his conduct would injure [the parent] unjustifiably, regardless of how far down the causal chain the injury would occur, [the former director] should have refrained from the conduct, especially where he stood to benefit at [the parent's] expense, and, at a minimum, should have disclosed those activities to [the parent].** Likewise, [the parent] has offered reasonable arguments that [the former director] may have violated his duties as a director of [the parent] by improperly misappropriating opportunities of [the parent] by virtue of his actions at [the subsidiary]. **Accordingly, I find that [the parent] has standing to assert direct claims for breach of fiduciary duty against [the former director].**

Id. at *7 (footnote omitted) (emphasis added).

Similarly, in Unzipped Apparel, LLC v. Sweet Sportswear, LLC, 2010 WL 2677441 (Cal. Ct. App. Aug. 4, 2010), a California appellate court arrived at the same conclusion. In Unzipped, a parent-corporation ("Candie's") sued its former director ("Guez") for breach of fiduciary duty, alleging that he improperly used resources of Candie's wholly-owned subsidiary ("Unzipped") to set up a competing product line. Id. at *6, *36-*37. Following trial, Guez appealed, arguing that Candie's, as a parent corporation, lacked standing to assert a direct breach of fiduciary duty claim when its asserted damages were based on the indirect harm suffered by Unzipped, its wholly-owned subsidiary. Id. at *37.

Rather, he argued, that claim belonged to Unzipped, and could only be asserted by Candie's via a derivative action. Id.

Applying Delaware law, the Unzipped court rejected this argument, concluding that while a parent corporation "generally may not bring a direct action for breach of fiduciary duty for injury done to a subsidiary corporation," there are exceptions to this rule. Id. One of those exceptions is where:

> **[T]he defendant is a director of the parent corporation only, but has knowledge of injury to the subsidiary that will also harm the parent.** Thus, "[t]o the extent that members of the parent board are on the subsidiary board *or have knowledge of proposed action at the subsidiary level that is detrimental to the parent,* they have a fiduciary duty, as part of their management responsibilities, to act in the best interests of the parent and its stockholders." … After all, a "wholly-owned subsidiary functions to benefit its parent."

Id., citing Case Financial, 2009 WL 2581873, at *6 & fn. 37 (emphasis added). Notably, the Unzipped court also specifically addressed Guez's reliance on Tooley to support his argument that Candie's could only assert its breach of fiduciary duty claim through a derivative action, concluding that:

> Defendants' reliance on *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.* (Del.2004) 845 A.2d 1031, is misplaced… It may be, as defendants argue, that because Candie's was a shareholder of Unzipped, Candie's as a shareholder might not have been able under the *Tooley* court's two-part test to bring direct claims against Guez for harming Unzipped, assuming Guez were a director of Unzipped (which he wasn't). **Candie's, however, was more than just a shareholder of Unzipped. Candie's was a parent corporation on whose board of directors Guez sat, and to whom Guez owed fiduciary duties directly. Candie's is the only entity that can bring an action against Guez for breaching his fiduciary duties to Candie's by**

> **harming and diverting resources from one of the assets of Candie's, namely, its wholly-owned subsidiary Unzipped. The claim in this action belonged to Candie's, not to Unzipped.**

Id. at *38, n.36 (emphasis added). The same holds true here: Just as Guez was only a director of Candie's (the parent) and owed it a direct fiduciary duty, so too here, Trading was only in contractual privity with NAF (the parent) and owed NAF a direct contractual duty. And, just as the Unzipped court found that Tooley does not bar Candie's (the parent) from asserting a direct claim for breach of fiduciary duty – even though its damages are based on the indirect harm done to its wholly-owned subsidiary – so too this Court should conclude that Tooley does not prohibit NAF from asserting a direct claim for breach of contract – even though its damages are based on the indirect harm done to its wholly-owned subsidiaries. See also General Rubber Co. v. Benedict, 109 N.E. 96 (N.Y. 1915) (holding that a parent corporation may maintain a direct action against its director who had permitted misappropriation of the assets of a subsidiary, because the director owed an independent fiduciary duty to the parent to see that the subsidiary was not injured); Pointe San Diego Residential Community, L.P. v. W.W.I Properties, L.L.C., 2007 WL 1991205, at *10 (Cal. Ct. App. Jul. 11, 2007) (ruling that "a shareholder of a parent corporation may bring a derivative action against a controlling shareholder/director of the parent based on the latter's breaches of fiduciary duty owed to a subsidiary corporation also under the controlling

shareholder/director's control, when the actionable conduct causes injury to the parent as well as the subsidiary. The fact that a derivative action could also be maintained on behalf of the subsidiary based on the same wrongful conduct does not necessarily bar the derivative action on behalf of the parent").

Applying the holdings of these precedents to cases like this one – in which the shareholder is a corporate entity, asserting non fiduciary breach claims – is a logical extension. **Indeed, courts have already done this**. Lawrence Ins. Group, Inc. v. KPMG Peat Marwick L.L.P., 5 A.D.3d 918 (N.Y. App. Div. 3d Dep't 2004) is just such an example. In Lawrence, plaintiff, a parent-holding company, contracted with defendant, an accounting firm, to furnish accounting services for both itself and its wholly owned subsidiary. The foregoing included performing an actuarial review of the sufficiency of the subsidiary's capital reserves. Id. It was subsequently discovered that a $35 million deficit existed in the subsidiary's reserves. Id. The subsidiary was placed into liquidation, and all its property vested in the appointed liquidator. Id. Plaintiff sued defendant asserting claims for breach of contract and accounting malpractice. Id. Defendant moved for summary judgment, arguing that plaintiff lacked standing to assert its claims, which was denied by the trial court, and subsequently appealed. Id. at 918-199. Upholding the trial court's ruling, the appellate court explained:

> With respect to the standing issue, defendant correctly argues that a shareholder, even a sole shareholder or one in a closely held

> corporation, typically does not have standing to sue for injuries to the corporation itself… **However, where a defendant owes an independent duty to the shareholder and the shareholder and the defendant are in privity, the shareholder may sue for damages caused by the defendant's negligence which results in injury that is personal to the shareholder and independent of the damage caused to the corporation… Often, such damages consist of loss in value of the plaintiff's shares in the corporation[.]**

Id. (citations omitted) (emphasis added). See also Inn Chu Trading Co., Ltd. v. Sara Lee Corp., 810 F. Supp. 501, 505, n.7 (S.D.N.Y. 1992) (internal citations omitted) (emphasis added) (Noting that a party "**does not lose its right to enforce that obligation which runs directly to it simply because [its subsidiary] has sued for the same underlying injury.** It is a fundamental principle that "[t]he wrong does not cease to be remediable because it may also be a wrong to someone else""); In re First Cent. Financial Corp., 269 B.R. 502, 510, 513 (E.D.N.Y. Bankr. 2001) (ruling that trustee of estate of bankrupt holding company had standing to pursue claims against officers and directors of holding company for their alleged breach of fiduciary duties owed to company, even though he was asserting direct claim on behalf of debtor holding company itself and not in its capacity as sole shareholder of subsidiary, though most of officers and directors named as defendants were also officers or directors of subsidiary and noting that "one of these causes of action does not disappear merely because the director of the two corporations is the same person").

For these reasons, NAF is not barred by Tooley in bringing the action, but should be entitled to assert a direct claim for breach of contract against Trading.

ii. Application Of *Tooley* To This Matter Conflicts With Established Precedent In The Law Of Contract, And Produces Anomalous Results Inconsistent With The Goals Of Shareholder Derivative Litigation

That NAF should be able to bring a direct action and not be required to institute a shareholder derivative action is not only supported as an extension of existing case law, but is also supported by the fact that a contrary rule would conflict with existing precedent in the law of contract and also yields anomalous results that weaken the goals of shareholder derivative actions.

Assuming that the Contract conferred some beneficial right upon the NAF Subsidiaries to sue for its breach as third-party beneficiaries, it is fundamental that the existence of any such right would not operate to displace the direct contractual right of NAF to bring suit. In an unprecedented departure from third-party beneficiary law, however, the district court held that the creation of that right in the NAF Subsidiaries eliminated what would be a plainly co-existent contractual right in NAF. As the Second Circuit explained, imposing a shareholder derivative action upon the facts presented in this matter:

> **[C]onflicts with fundamental principles of contract law. As a general proposition, a party that obtains the contractual commitment of another may sue to remedy a breach of that contractual commitment.** When the commitment is to render a benefit to a third party, the doctrine of third-party beneficiary contract

> allows the benefitted third party also to sue to enforce the promise, notwithstanding that it was not a party to the contract. But the rule that allows a third-party beneficiary to sue in order to preserve the promised benefit to itself does not disable the party to which the contractual commitment was made from suing to enforce the commitment made to it.

NAF II at 747 (internal citation omitted) (emphasis added). This conclusion is confirmed by the authorities discussed above. See, e.g., Hikita, 713 P.2d at 1200-1201 ("A shareholders agreement for the benefit of a corporation does create a duty running to both the corporation and the promisee. Section 305(1) of the Restatement (Second) of Contracts (1981) makes this clear: A promise in a contract creates a duty in the promisor to the promisee to perform the promise even though he also has a similar duty to an intended beneficiary"); Lawrence, 5 A.D.3d at 918-919.

Furthermore, the district court's unprecedented displacement of NAF's direct contractual right cannot be supported through the argument that its rights can be vindicated through an action by the NAF Subsidiaries as third-party beneficiaries of the Contract. As the Second Circuit explained:

> It is no sufficient answer that the rights of the contracting party to enforce the promise made to it would be protected through a suit brought by the third-party beneficiary. There are many likely reasons why the third-party beneficiary cannot be depended upon to sue and thus protect the interest of the party that secured the promise. NAF II at 747.

The Second Circuit elucidated this conclusion by presenting a hypothetical whereby an agent contracts with a performer whereby he receives 25% of the revenue the latter receives as a result of his efforts. Id. The agent then enters into a contract with a club to secure the performer's performance for an agreed upon sum of money, but the club subsequently renounces the contract by refusing to book the performer. Id. As a result of the club's breach, the agent – as a third-party beneficiary – has suffered a loss in the amount of 25% of the sum the club agreed to pay the performer. "Without question," the Second Circuit asserted, however "Performer could sue Club, but Performer may not wish to do so, because Performer reasonably believes that suing Club would harm Performer's prospects of obtaining future work." Id. As such, "Agent's only recourse to recover his loss is to sue Club for his [] loss, based on Club's breach of the contractual commitment it made directly to Agent…

> We think it would make little sense in this scenario to bar Agent from suing on the grounds that the loss he suffered was indirect and derivative of a loss suffered by an independent person. The defendant owed a contractual commitment directly to the plaintiff and breached it, causing the plaintiff a loss. **The fact that the plaintiff's loss resulted indirectly from a loss suffered by an independent third-party beneficiary should make no difference to the plaintiff's right to sue for the breach of a contractual promise to itself.**

Id. at 747-748 (emphasis added). Applying this reasoning to the facts presented here, the Second Circuit asserted that:

> **[W]e have difficulty seeing why the results should be otherwise merely because the third-party beneficiary of the contract is a corporation in which the plaintiff owns stock.** Without question, the third-party beneficiary corporation is a separate entity independent of the plaintiff, but if the fact of independence does not bar direct suit by the contracting party to enforce a promise made directly to itself when the contracting party has no shareholder's ownership interest in the third-party beneficiary, **we can see no reason why the result should be otherwise merely because the plaintiff owns stock in the third-party beneficiary.**

Id. at 748 (emphasis added). As such, the resulting interference with established principles of the law of contract further supports the conclusion that a shareholder derivative action should not be imposed upon the facts of this case.

Furthermore, a rule prohibiting NAF from bringing direct suit on its claim would result in a wholly inequitable rule of law whereby parties often could and would suffer contractual wrongs *without the benefit of any available remedy*. Putting aside those situations referenced by the Second Circuit in which a subsidiary third-party beneficiary may be disincentivized from enforcing a parent company's interests, there are also equally plausible hypotheticals whereby a parent company enters into a contract for which there is no "intended third-party beneficiary" with standing to pursue a claim. In such a case, the parent company nonetheless may suffer harm through its subsidiary yet be left with no right to pursue a claim directly, and also have no subsidiary positioned to assert the claim. In such cases, a counter-party to a contract will have breached a contract, without any plaintiff available to pursue a claim.

Yet another incongruous result that emerges under Delaware law by imposing a derivative action in such situations is that while the parent corporation *may not* institute a direct action against the unaffiliated contracting counterparty for breach of contract, it is undisputable that the unaffiliated contracting counterparty *may* institute an action for breach of contract against the parent corporation.[10] These irreconcilable disparities only further demonstrate the resulting interference with established principles of the law of contract that arise by imposing a derivative action upon the facts of this case.

The foregoing interferences with the established law of contract also serve to underscore the difficulties inherent in Judge Lynch's concurrence. Judge Lynch expressed two concerns – one substantive and one procedural. Substantively, Judge Lynch questioned that because "[t]he many benefits of limited liability… are built on the idea that every corporation is a distinct legal person from its parent or subsidiary corporations and from its various shareholders," permitting a parent corporation to institute a direct action for breach of contract when its damages amount to diminution of value of its shares in a subsidiary "fails to give sufficient

[10] Nor is this result alleviated in those situations where the subsidiary does qualify as a third-party beneficiary, as "no rule of Delaware law imposes liability on a third party beneficiary who was not a party to the contract." RHA Construction, Inc. v. Scott Engineering, Inc., 2013 WL 3884937, at *9 and n.93 (Del. Super. May 24, 2013), citing Rob-Win, Inc. v. Lydia Sec. Monitoring, Inc., 2007 WL 3360036, at *4 (Del. Super. Apr. 30, 2007) (internal citations and footnotes omitted) (finding "no case law imposing an obligation on the third-party beneficiary" to a contract, and stating that it "knows of no rule or law nor any reason why a third party beneficiary should be liable on a contract to which it was not a party").

weight to a very basic point about corporate personhood." NAF II at 751 (Lynch, C.J., concurring). Procedurally, Judge Lynch asked whether "[t]here is something peculiar in permitting a different member of the same corporate empire, which was fortuitously or strategically omitted from that settlement, to bring an action qua shareholder of the companies that agreed, for consideration, not to pursue the claim." Id. at 752 (Lynch, C.J., concurring).

First, Judge Lynch's substantive question – concerning the distinct identity of a subsidiary corporation in such situations – actually favors a rule permitting NAF to sue directly to enforce the contract to which it itself was the contract party. In other words, while it is undeniable that a corporation – as a distinct legal entity – would ordinarily be permitted to institute a direct action against a third-party for breach of contract, here the parent otherwise would be summarily denied its right based on the existence of a separate and distinct legally affiliated entity.

As for, and with all due respect to, Judge Lynch's comment that "permitting a different member of the same corporate empire" to institute a cause of action in such cases seems "peculiar," see id. at 752 (Lynch, C.J., concurring), the reality is that, as the Second Circuit majority observed, such questions are "**irrelevant** to the

specific question of whether Delaware law would hold that NAF's claim against Trading is direct or derivative." Id. at 746, n.5 (emphasis added). [11]

In addition to the fact that requiring a shareholder derivative action in this case would conflict with established precedent in the law of contract – and, potentially, corporate law – it would also yield anomalous results within the internal structure of the laws governing derivative actions, and their intended rationales. Ordinarily, it is a *corporate defendant* that may assert as an affirmative defense that a direct claim must be barred because it can only be asserted derivatively. Even in those situations where third-parties may assert this defense themselves, they have been permitted to do so for the express purpose of affording *the corporate defendant* an opportunity to address the alleged wrong and control the litigation.[12] In the circumstances presented in this case, however, imposing the requirement of instituting a shareholder derivative action upon NAF would result in Trading being able to assert this defense. This is so, despite the fact that

[11] Moreover, NAF – "a different member of the same corporate empire," see NAF II at 752 (Lynch, C.J., concurring) – is not attempting to institute an action against the same entity that Gerszberg and the NAF Subsidiaries already settled with – Hampshire – *but a completely different entity* that was not even party to the Settlement Agreement.

[12] See, e.g., 13 Fletcher Cyc. Corp. § 5957 ("Failure to comply with preconditions") (Sep. 2014) (footnotes omitted) (emphasis added) ("The failure to comply with preconditions may be raised as a defense to a derivative proceeding. Courts have held that a third party may assert demand related defenses, although there is authority to the contrary. Permitting a third party to raise such defenses **serves the underlying purpose of assuring that the shareholder gives the corporation the opportunity to address the alleged wrong without litigation and to control any litigation that does occur.** Directors who are named defendants in a derivative proceeding and participated in a decision to delegate control over the litigation to a special committee cannot subsequently bring a motion to dismiss on the basis of the plaintiff's failure to make a demand").

Trading is a third-party outsider that would assert the defense solely to protect itself, and not to effectuate its intended purpose – namely, *protecting the rights of the corporate entity*.

This anomalous result did not escape the Second Circuit's analysis. Indeed, it specifically linked this result with the fact that this case does not present a more common claim of breach of fiduciary duty by corporate insiders, noting that since the rule specifically permits "defendant[s] (rather than the corporation[s]) to raise the objection to the suit being brought directly by the shareholder,"

> **[I]t makes far better sense when the asserted liability of the defendant is predicated on legal duties imposed by virtue of the defendant's fiduciary obligations to the corporation than when the defendant's asserted liability is predicated on his having undertaken a contractual commitment to the plaintiff… [I]t makes little sense to allow [a] *defendant* [who has breached a contractual obligation] to protest that the plaintiff, to whom the promise of performance was made, cannot sue directly to remedy breach of the promise.** In such circumstances, the defendant, whose only involvement with the corporation results from having contracted with the plaintiff to render services to it, **has no cognizable interest in the protection of the corporation's power to make decisions independent of its shareholder.**

Id. (emphasis added). As such, in "a case like this one," where "the defendant has no relationship to the corporation in which the plaintiff owns stock, other than the relationship that arises from the defendant's contractual undertaking," "literal adherence to the formulation of the Tooley dictum" is not warranted. Id. at 749, n.7.

For these reasons, NAF should be entitled to assert its claim of breach of contract directly against Trading.

CONCLUSION

For all the foregoing reasons, it is respectfully requested that this Court clarify that a party (promisee) to a contract has the right to pursue a direct breach of contract claim against the other party (promisor) to the contract notwithstanding that the third-party beneficiary of the contract is a corporation in which the promisee owns stock, and the promisee's loss derives indirectly from the loss suffered by the third-party beneficiary corporation.

Respectfully submitted,

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