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IN THE SUPREME COURT OF THE STATE OF DELAWARE

NAF HOLDINGS, LLC,	§	
	§	
Plaintiff/Counter-Defendant, Appellant,	§ §	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.
v.	§	
	§	
LI & FUNG (TRADING) LIMITED,	§	
	§	
Defendant/Counter-Claimant, Appellee.	§ §	
	§	

ANSWERING BRIEF OF DEFENDANT/COUNTER-CLAIMANT, APPELLEE LI & FUNG (TRADING) LIMITED

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TABLE OF CONTENTS

Page

NATURE OF PROCEEDINGS 1

SUMMARY OF ARGUMENT..3

STATEMENT OF FACTS 4

A. The Parties

B. Factual Background 5

C. Procedural History 7

1. The District Court Dismisses NAF's Claim.................... 7

2. The Second Circuit Certifies A Question Of Law........... 8

ARGUMENT 10

A. Question Presented.. 10

B. Scope of Review 10

C. Merits of the Argument... 11

1. *Tooley* Bars Any Direct Claim By NAF........................ 11

2. There Is No Reason To Abandon Or Modify *Tooley*... 14

a. *Tooley* Applies To Contract Claims 15

b. *Tooley* Bars Direct Claims Where Plaintiff Has Not Suffered Independent Injury......................... 16

c. Applying *Tooley* Here Fosters The Purposes Of The Direct/Derivative Distinction 17

d. NAF's Reliance On The Hypotheticals Discussed By The Second Circuit Is Misplaced................... 21

3. The Application of *Tooley* Here Is Consistent With Established Delaware Law.. 22

4. NAF's Reliance On Out-of-State Cases Is Of No Avail 29

CONCLUSION 33

TABLE OF AUTHORITIES

Page(s)

Cases

Adelphia Recovery Trust v. Bank of America, N.A.,
2010 WL 2077214 (S.D.N.Y. May 14, 2010) 13, 14

Agostino v. Hicks,
845 A.2d 1110 (Del. Ch. 2004) 12, 14

Baccash v. Sayegh,
53 A.D.3d 636 (N.Y. App. Div. 2d Dept. 2008) 32, 33

In re Beck Industries, Inc.,
479 F.2d 410 (2d Cir. 1993) 25

Bennett v. Breuil Petroleum Corp.,
99 A.2d 236 (Del. Ch. 1953) 28

Boise Cascade Corp. v. Wheeler,
419 F. Supp. 98 (S.D.N.Y. 1976), *aff'd without opinion*,
556 F.2d 554 (2d Cir. 1977) 25

Brister v. Schlinger Found.,
469 F. Supp. 2d 371 (E.D. La. 2007) 26

Caravel Acad. v. Campbell,
1984 WL 19471 (Del. Ch. Mar. 27, 1984) 21

Cargill, Inc. v. JWH Special Circumstance LLC,
959 A.2d 1096 (Del. Ch. 2008) 24

Case Financial, Inc. v. Alden,
2009 WL 2581873 (Del. Ch. Aug. 21, 2009) 13

Chambrella v. Rutledge,
740 P.2d 1008 (Haw. 1987) 30

Delgadillo v. White,
2008 WL 4095494 (Ariz. Ct. App. Apr. 22, 2008) 30

Dinuro Investments, LLC v. Camacho,
141 So.3d 731 (Fla. Dist. Ct. App. 2014).. 29

In re Enron Corp. Sec., Derivative & "ERISA" Litig.,
2007 WL 789141 (S.D. Tex. Mar. 12, 2007) 26

Eurofins Panlabs, Inc. v. Ricerca Biosciences, LLC,
2014 WL 2457515 (Del. Ch. May 30, 2014) 22

Feldman v. Cutaia,
951 A.2d 727 (Del. 2008).. 12, 26

In re First Cent. Financial Corp.,
269 B.R. 502 (E.D.N.Y. 2001) 31

General Rubber Co. v. Benedict,
109 N.E. 96 (N.Y. 1915) 31

Grill v. Aversa,
2014 WL 4672461 (M.D. Pa. Sep. 18, 2014).. 30

Hartsel v. Vanguard Grp., Inc.,
2011 WL 2421003 (Del. Ch. June 15, 2011), *aff'd*, 38 A.3d
1254 (Del. 2012).. 26

Hawkins v. Gilbo,
663 A.2d 9 (Me. 1995) 28

Hikita v. Nichiro Gyogyo Kaisha, Ltd.,
713 P.2d 1197 (Alaska 1986) 30

Inn Chu Trading Co. v. Sara Lee Corp.,
810 F.Supp 501 (S.D.N.Y. 1992) 31

In re J.P. Morgan Chase & Co. S'holder Litig.,
906 A.2d 808 (Del. Ch. 2005), *aff'd*, 906 A.2d 766 (Del.
2006) 13

Johnson & Johnson v. Coopervision, Inc.,
720 F. Supp. 1116 (D. Del. 1989) 24, 25

Kramer v. W. Pac. Indus., Inc.,
546 A.2d 348 (Del. 1988).. 26

Krier v. Vilione,
766 N.W.2d 517 (Wis. 2009) 29

Lawrence Ins. Grp. v. KPMG Peat Marwick,
5 A.D.3d 918 (N.Y. App. Div. 3d Dept. 2004) 31

Lorenzetti v. Hodges,
62 A.3d 1224 (Del. 2013).. 22

MCG Capital Corp. v. Maginn,
2010 WL 1782271 (Del. Ch. May 5, 2010) 15

Metro. Life Ins. Co. v. Tremont Grp. Holdings, Inc.,
2012 WL 6632681 (Del. Ch. Dec. 20, 2012) 13

NAF Holdings, LLC v. Li & Fung (Trading) Ltd.,
2013 WL 489020 (S.D.N.Y. Feb. 8, 2013) .... *passim*

NAF Holdings, LLC v. Li & Fung (Trading) Ltd.,
772 F.3d 740 (2d Cir. 2014) .... *passim*

NAMA Holdings, LLC v. Related World Mkt. Ctr., LLC,
922 A.2d 417 (Del. Ch. 2007) 28

Outten v. State,
702 A.2d 547 (Del. 1998).. 10

Pointe San Diego Residential Community, L.P. v. W.W.I. Properties, L.L.C.,
2007 WL 1991205 (Cal. Ct. App. Jul. 11, 2007) 30

Ruffalo v. Transtech Services Partners Inc.,
2010 WL 3307487 (Del. Ch. Aug. 23, 2010).. 15

Sagarra Inversiones, S.L. v. Cementos Portland Valderrivas, S.A.,
34 A.3d 1074 (Del. 2011) 21, 26

Schuster v. Gardner,
25 Cal. Rptr. 3d 468 (Cal. Ct. App. 2005)... 31

Seligman v. McVeigh,
1983 WL 413312 (Del. Super. Aug. 17, 1983) 28

Serino v. Lipper,
123 A.D.3d 34 (N.Y. App. Div. 1st Dept. 2014) 31, 32

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

Universal Enter. Grp., L.P. v. Duncan Petroleum Corp.,
2013 WL 3353743 (Del. Ch. July 1, 2013) 22

Unzipped Apparel, LLC v. Sweet Sportswear, LLC,
2010 WL 2677441 (Cal. Ct. App. Aug. 4, 2010) 30

Valley Forge Christian College v. Americans United for Separation of Church and State, Inc.,
454 U.S. 464 (1982)... 23

VLIW Tech., LLC v. Hewlett-Packard Co.,
840 A.2d 606 (Del. 2003)... 22

Williams v. Habul,
724 S.E.2d 104 (N.C. Ct. App. 2012)... 28

Wilson v. Hayes,
77 A.3d 392 (D.C. 2013) 27

Yuddell v. Gilbert,
99 A.D. 3d 108 (N.Y. App. Div. 1st Dept. 2012) 15, 31

Other Authorities

17B C.J.S Contracts § 843 28

13 Williston on Contracts § 37:55 (4th ed.) 27

25 Williston on Contracts § 67:112 (4th ed.) 27

Cal. R. Ct. 8.1115 30

Daniel S. Kleinberger, *Direct Versus Derivative and the Law of Limited Liability Companies*, 58 BAYLOR L. REV. 63, 91 (2006)... 23, 24

Restatement (Second) of Contracts § 307 (1981).. 28

NATURE OF PROCEEDINGS

This proceeding arises out of the certification of a legal question by the United States Court of Appeals for the Second Circuit ("Second Circuit") to this Court in *NAF Holdings LLC v. Li & Fung (Trading) Limited*. Plaintiff NAF Holdings, LLC ("NAF") sued Defendant Li & Fung (Trading) Limited ("Trading") in the United States District Court for the Southern District of New York ("District Court") under an alleged Buying Agent Agreement ("BAA"). NAF seeks, however, to recover damages suffered (if at all) by a separate corporate entity, *i.e.*, its <u>indirect</u> subsidiary, NAF Acquisition Corp. ("Acquisition"). Acquisition purportedly was damaged in connection with the termination of a merger agreement ("Merger Agreement") between Acquisition and its immediate parent NAF Holdings II LLC ("NAF II", together with Acquisition, the "NAF Subsidiaries") and the merger target, Hampshire Group Limited ("Hampshire"). Even though Acquisition voluntarily abandoned the merger and subsequently released any claims it may have had concerning that transaction, NAF now seeks to recover from Trading the alleged loss of the value of that transaction.

The District Court correctly dismissed NAF's claim, finding that the claim was derivative, not direct, because NAF incurred no direct damages. It is undisputed that the only possible harm to NAF was a diminution in the

value of the stock it owned in the NAF Subsidiaries. The District Court based its dismissal on the clear and unambiguous guidelines set forth by the Court in *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1035 (Del. 2004).

On appeal, the Second Circuit referred to this Court an issue of Delaware law as to whether the facts of this case justify a modification or exception to *Tooley* so as to allow a direct claim by NAF.

It is indisputable that *Tooley* precludes a direct claim by NAF. In essence, NAF espouses abandoning or modifying *Tooley* in favor of allowing a direct claim where the claimant has not suffered direct damages but only a loss in the value of its investment in a corporation. This Court should decline to implement such a drastic and unwarranted change in Delaware law.

SUMMARY OF ARGUMENT

1. Denied. *Tooley* applies and bars NAF from asserting a direct claim against Trading. NAF asserts no direct, independent damages. Rather, NAF seeks to recover for the diminution in value of the stock it holds in the NAF Subsidiaries. Such a claim is derivative under *Tooley*. The application of *Tooley* to bar NAF's claim here is consistent with Delaware's requirement that to bring a direct claim a plaintiff must have suffered a direct injury, *Tooley*, 845 A.2d at 1037, and is consistent with the purposes of the direct/derivative distinction in Delaware. Applying *Tooley* here is also consistent with numerous well-established principles of Delaware law, which require that a party suffered direct injury in order to assert a claim.

STATEMENT OF FACTS

A. The Parties

NAF is a Delaware limited liability company owned by an individual, Efrem Gerszberg ("Gerszberg"). While NAF was formed for the purpose of acquiring Hampshire, a public company that is in the apparel business, it was not the entity that actually contracted to purchase Hampshire. *NAF Holdings, LLC v. Li & Fung (Trading) Ltd.*, 2013 WL 489020, at *1 (S.D.N.Y. Feb. 8, 2013). NAF was not a party to the Merger Agreement. *Id.* at *2. Instead, the merger was to be implemented through NAF's two subsidiaries, NAF II and Acquisition. *Id.*

NAF II is a Delaware limited liability company owned by NAF. It is not a party to this litigation, but it was a party to the Merger Agreement. Acquisition is a Delaware corporation and is a subsidiary of NAF II. *NAF Holdings, LLC v. Li & Fung (Trading) Ltd.*, 772 F.3d 740, 741 (2d Cir. 2014). Acquisition is not a party to this litigation, but it was a party to the Merger Agreement. The Merger Agreement provides that Acquisition would be the entity that would purchase Hampshire. *NAF Holdings*, 2013

WL 489020, at *2. Trading is a Hong Kong company in the business of providing sourcing services to its customers, mainly apparel companies.[1]

B. Factual Background

In December 2008, NAF and Trading negotiated the BAA, whereby Trading would act as the exclusive sourcing agent for Hampshire after NAF acquired Hampshire.[2] *Id.* at *1. In February 2009, Gerszberg received a loan commitment from Wells Fargo Trade Capital LLC ("Wells Fargo") to fund Hampshire's operations post-closing. This commitment was conditioned upon the existence of a valid sourcing agreement between Trading and Hampshire post-merger.

Also in February 2009, the NAF Subsidiaries entered into the Merger Agreement with Hampshire, whereby Acquisition would buy Hampshire's stock through a tender offer. *NAF Holdings*, 772 F.3d at 741. The Merger Agreement contained a number of representations, including that the BAA between NAF and Trading was valid and effective, and that there was a loan

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[1] As a sourcing agent, Trading assists its customers in placing orders with factories; acts as the paying agent/intermediary between its customers and the factories; assists its customers in negotiating terms with the factories; monitors production orders; and provides inspection and quality assurance services.

[2] While the parties disagree on whether the BAA was binding and enforceable, for purposes of its Motion for Summary Judgment, Trading agreed, *arguendo*, that the District Court should assume that it was binding.

commitment from Wells Fargo. *NAF Holdings*, 2013 WL 489020, at *2. NAF was not a party to the Merger Agreement.

In March 2009, Trading learned during due diligence that Hampshire's financial condition had deteriorated drastically. In light of this deterioration, Trading invoked its rights under the BAA and requested that NAF provide additional security for Trading's obligations. After NAF refused to provide the requested security, Trading exercised its right to terminate its business relationship with NAF.[3]

After Trading's relationship with NAF ended, the NAF Subsidiaries continued their efforts toward completion of the merger. Specifically, they executed several amendments to the Merger Agreement, replaced Trading as the sourcing agent, and obtained alternative financing from Wells Fargo. *NAF Holdings*, 2013 WL 489020, at *3.

Acquisition terminated the Merger Agreement on April 26, 2009. At the time, Gerszberg repeatedly and unequivocally stated (including under oath) that the reason for the termination was Hampshire's breach of covenants set forth in the Merger Agreement and Hampshire's eroding financial condition. *NAF Holdings*, 2013 WL 489020, at *3.

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[3] NAF disputes that Trading was entitled to terminate the relationship.

Following the termination of the Merger Agreement, Gerszberg and his companies threatened various claims against Hampshire based on, among other things, the failure to consummate the merger. These claims were settled pursuant to a Settlement Agreement whereby Hampshire paid the NAF Subsidiaries $833,000 in exchange for a release by Gerszberg and the NAF Subsidiaries of all claims against Hampshire and an agreement by Gerszberg and the NAF Subsidiaries (but not NAF) not to sue any person or entity for damage or losses relating to the failed merger. *NAF Holdings*, 772 F.3d at 742.

After the NAF Subsidiaries extracted over $800,000 from Hampshire, NAF set its sights on Trading by commencing the District Court action, claiming for the first time that the reason the merger did not close was not Hampshire's breaches -- as it had previously maintained -- but instead Trading's alleged breach of the BAA.

C. <u>Procedural History</u>

1. <u>The District Court Dismisses NAF's Claim</u>

After discovery in the District Court, Trading moved for summary judgment. On February 8, 2013, the District Court granted summary judgment against NAF.

The District Court found that NAF failed to prove it had suffered any independent loss. *NAF Holdings*, 2013 WL 489020, at **6-10. The District Court found that the alleged damage that NAF sought to recover, if any, belonged exclusively to the NAF Subsidiaries -- and not NAF -- and that applicable law did not permit NAF to recover the damages suffered exclusively by the NAF Subsidiaries. *Id.* at *7. The District Court also found that the claim NAF sought to assert could not be asserted derivatively because the primary holders of the claim, the NAF Subsidiaries, had previously waived all claims they may have had as a result of the failed merger.[4] *Id*. at *10. NAF appealed.

2. The Second Circuit Certifies A Question Of Law

On November 17, 2014, the Second Circuit rendered a decision in which it certified to this Court the question whether a direct claim may be

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[4] The District Court emphasized that:

> [T]he decisive fact, fatal to NAF's claim, is that the NAF Subsidiaries no longer have a viable claim against Trading. Both subsidiaries relinquished any such claim in their settlement agreement with Hampshire. That broadly-worded agreement included an express waiver of claims by the NAF Subsidiaries and Gerszberg "against any person, whether or not a party to this Settlement Agreement to recover damages, attorneys fees, expenses of any type or any other losses allegedly sustained as a result of the Transaction Agreements or the Transaction." Settlement Agreement 13813 (§ 7) (emphasis added). At argument, counsel for NAF acknowledged that that language bars the NAF Subsidiaries from suing Trading. It thus equally bars their shareholders, NAF, from suing Trading derivatively on their behalf.

NAF Holdings, 2013 WL 489020, at *10.

brought under Delaware law on facts such as those present here. *NAF Holdings*, 772 F.3d at 750.

The Second Circuit noted that the District Court had followed Delaware law as articulated in *Tooley*, and found that under *Tooley* NAF had no direct claim against Trading. *NAF Holdings*, 772 F.3d at 741. The Second Circuit, however, stated that *Tooley* and its progeny involved the typical derivative suit whereby a minority shareholder seeks to redress an injury to the corporation usually caused by its officers, directors or majority shareholder, *i.e.*, a dispute among insiders of the corporation, whereas the instant case involved a duty owed by an outsider of the corporation. The Second Circuit questioned whether this Court would apply *Tooley* to the facts of this case, and further suggested that this Court should either modify *Tooley* or carve out an exception to it based on the facts here. *NAF Holdings*, 772 F.3d at 745-46. For the reasons set forth below, Trading respectfully submits that *Tooley* should not be modified, but that this Court should hold that *Tooley* does apply and bars a direct claim under the facts present here and contained in the question certified by the Second Circuit.

ARGUMENT

A. Question Presented

"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 [(i)] 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?" *NAF Holdings*, 772 F.3d at 750.

B. Scope of Review

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*, 702 A.2d 547, 551 (Del. 1998).

C. Merits of the Argument

1. *Tooley* Bars Any Direct Claim By NAF

NAF seeks to assert a claim against Trading based upon damages incurred by its indirect subsidiary, Acquisition.[5] Under these circumstances, Delaware law bars any direct claim by NAF.

This Court in *Tooley* clarified the proper test for determining whether a claim is direct or derivative, holding that:

> [t]he analysis must be based solely on the following questions: Who suffered the alleged harm -- the corporation or the suing stockholder individually -- and who would receive the benefit of the recovery or other remedy?

Tooley, 845 A.2d at 1035. The Court in *Tooley* pointed out that the key issue is whether NAF can demonstrate that it "can prevail without showing an injury to the corporation." *Id.* at 1036. "In other words, the inquiry should focus on whether an injury is suffered by the shareholder that is not

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[5] As the District Court stated:

> pressed at argument to be concrete as to the nature of the injury, NAF stated only that its subsidiaries had lost value as a result of the failed merger, and that NAF was thus injured in is capacity as the 100% shareholder/owner of the subsidiaries. The Court then asked counsel for NAF whether NAF suffered any injury other than through the diminished value of the subsidiaries that it wholly owned. NAF's counsel identified none.

NAF Holdings, 2013 WL 489020, at *6.

dependent on a prior injury to the corporation." *Agostino v. Hicks*, 845 A.2d 1110, 1122 (Del. Ch. 2004).

Here, Acquisition -- the company that was to purchase Hampshire -- not NAF, was harmed and is entitled to any recovery. The only damage asserted by NAF is derivative, indeed double derivative, *i.e.*, the loss in value of its direct subsidiary NAF II, which purportedly lost value based upon the loss in value of its subsidiary, Acquisition, when Acquisition did not acquire Hampshire. NAF cannot show injury without showing injury to NAF II, which itself cannot show injury without showing injury to Acquisition.

Both the District Court and the Second Circuit found that under *Tooley*, NAF had no direct claim against Trading. *NAF Holdings*, 772 F.3d at 745-46; *NAF Holdings*, 2013 WL 489020, at *7. NAF essentially concedes as much by arguing that *Tooley* should not apply. (NAF Br. at 11).

The notion that *Tooley* is "technically dicta" and that, therefore, "the language in *Tooley* is simply illustrative and non-precedential" (NAF Br. at 12) is wrong. The rule articulated in *Tooley* has been applied by this Court and by the Court of Chancery post-*Tooley*. *See Feldman v. Cutaia*, 951 A.2d 727, 732 (Del. 2008) ("If the corporation alone, rather than the individual stockholder, suffered the alleged harm, the corporation alone is

entitled to recover, and the claim in question is derivative"); *In re J.P. Morgan Chase & Co. S'holder Litig.*, 906 A.2d 808, 819 (Del. Ch. 2005) (holding that a claim that corporation overpaid for acquired company was derivative because shareholders "were harmed indirectly and only because of their ownership [of the corporation]" and "[a]ny remedy from the alleged harm would necessarily accrue to [the corporation]"), *aff'd*, 906 A.2d 766 (Del. 2006); *Metro. Life Ins. Co. v. Tremont Grp. Holdings, Inc.*, 2012 WL 6632681, at *9 (Del. Ch. Dec. 20, 2012).

NAF's reliance on *Case Financial, Inc. v. Alden* to suggest that Delaware law would support a direct claim here is misplaced. 2009 WL 2581873 (Del. Ch. Aug. 21, 2009). To the extent that *Case Financial* stands for the proposition that a parent corporation has standing to bring a direct claim for breach of fiduciary duties by its own directors and officers for injuries suffered by its subsidiary, it "departs from *Tooley*." *Adelphia Recovery Trust v. Bank of America, N.A.*, 2010 WL 2077214, at *8 (S.D.N.Y. May 14, 2010). The court in *Adelphia* found that *Case Financial* was not controlling, noting that it was "a lone decision by a trial court suggesting an exception to established Delaware law (as set forth by the Delaware Supreme Court)" (*id.* at *8), and that the plaintiff there cited no other case "suggesting that the *Tooley* shareholder standing test does not

apply with equal force to sole shareholder situations." *Id.* at *9. As explained below, a rule of law allowing parent corporations to sue for damages suffered only by their wholly-owned subsidiaries and not independently by the parent would be bad law.[6]

2. There Is No Reason To Abandon Or Modify *Tooley*

This Court in *Tooley* announced the test for distinguishing direct and derivative claims with the express purpose of providing a standard that was "clear, simple and consistently articulated and applied by our courts." 845 A.2d at 1036. *Tooley* has worked well for over ten years. It is straight-forward and well-reasoned. Simply put, "if it isn't broken, don't fix it."

Yet knowing that *Tooley* compels dismissal of its claim, NAF asks the Court to abandon or modify *Tooley*, without providing any legitimate justification for this radical change in Delaware law. NAF asserts "that the policies underlying shareholder derivative litigation can only be effectuated if and when applied to suitable cases, consisting of appropriate facts" (NAF Br. at 2), and appears to be advocating an abandonment of *Tooley*, whereby

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[6] NAF attempts to justify a departure from Tooley based on a misreading of *Agostino v. Hicks*. (NAF Br. at 16). In *Agostino*, when discussing what NAF characterizes as "other sorts of claims" "such as suits to enforce contractual commitments" that are being "analyzed differently," Chancellor Chandler refers to a situation where a corporation, owing a duty to allow a stockholder to vote, "wrongfully prevents [the] stockholder from exercising his or her right to vote, the stockholder may assert individual ownership over the claim." 845 A.2d at 1122 n.54. In that case, the harm is borne directly by the stockholder, not the corporation.

the courts would use a case-by-case analysis to determine whether to enforce the requirement that actions where the only independent harm is suffered by the corporation must be brought derivatively. Not only would such an approach be contrary to *Tooley*, it would be contrary to other well-established principles of Delaware law. (*See infra* Part C(3)).[7]

a. *Tooley* Applies To Contract Claims

NAF asserts that the facts here are different from a typical shareholder derivative action where the court is called to apply *Tooley*. It argues that the more conventional *Tooley* cases arise from internal corporate disputes involving claims for breach of fiduciary duties, whereas this case involves a contractual obligation to a corporate outsider.

Tooley, however, has been applied to analyze contract claims and does *not* preclude a shareholder that is owed a direct contractual duty from bringing a direct claim based on a breach of that duty, provided that two key prerequisites of the test are met: there is a breach of that duty and there is direct injury to the shareholder. *See*, *e.g.*, *MCG Capital Corp. v. Maginn*, 2010 WL 1782271, at *7 (Del. Ch. May 5, 2010); *Ruffalo v. Transtech Services Partners Inc.*, 2010 WL 3307487, at *9 (Del. Ch. Aug. 23, 2010).

[7] In contrast to NAF's request that the Court substitute a case by case approach for *Tooley*, New York Courts recently adopted the *Tooley* test in lieu of what had been a case-by-case approach. *Yuddell v. Gilbert*, 99 A.D. 3d 108, 110 (N.Y. App. Div. 1st Dept. 2012).

Thus, NAF's assertion that literal adherence to *Tooley* is not warranted here because the pending controversy involves a third-party contract as opposed to alleged breaches of fiduciary duty (NAF Br. at 31) misses the point. The alleged damages here were suffered by its indirect subsidiary, Acquisition, and, therefore, any claim against Trading belongs to Acquisition, not NAF. This is true even though the dispute is contractual.

b. *Tooley* Bars Direct Claims Where Plaintiff Has Not Suffered Independent Injury

Similarly, the argument that if NAF is prohibited from suing directly here, a rule of law will exist "whereby parties often could and would suffer contractual wrong *without the benefit of any available remedy*," (NAF Br. at 27) (emphasis is original) is meritless. Contractual claims for damages would only be barred when the putative plaintiff has not suffered independent damages and, even then, a damaged third-party beneficiary may bring suit.

What is unusual about this case is that Acquisition, the party that allegedly sustained the injury, did not bring the claim. Of course, Acquisition has already been compensated by Hampshire in an amount of over $800,000 for its damage resulting from the failure to complete the merger, and has otherwise released all claims relating to the failed merger.

NAF Holdings, 772 F.3d at 742. The fact that Acquisition has not sued because it released its claims is not a basis for abandoning *Tooley*.

c. Applying *Tooley* Here Fosters The Purposes Of The Direct/Derivative Distinction

Moreover, while this case does not involve an internal corporate dispute, it does raise significant issues concerning the relationship between a parent and its direct and indirect subsidiaries. It is the presence of these issues that mandates a *Tooley* analysis.

Rather than impairing the underlying purposes of derivative actions, strict application of the *Tooley* test to the facts present here fosters those purposes. As acknowledged by NAF and emphasized by the Second Circuit, one of the purposes of the rule requiring certain actions to be brought only derivatively 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." *NAF Holdings*, 772 F.3d at 746.

Applying *Tooley* here fosters this purpose. *First,* it honors the separateness between the parent and subsidiary by not allowing NAF to claim damages suffered by its indirect subsidiary, which would otherwise blur the distinction between the distinct corporations. *Second,* it mandates that the company that actually was harmed -- Acquisition -- control the

decision how to address whatever damage it incurred as a result of the failed merger, thereby fostering corporate autonomy. Acquisition's decision in this case was to obtain payment from Hampshire and release all other parties.

Strict adherence to *Tooley* also avoids potential unfair and unworkable results. For example, putting aside the issue of the NAF Subsidiaries' release of claims, if NAF were permitted to sue directly, the creditors of the true party in interest -- Acquisition -- may be prejudiced. In addition, if it is determined that NAF has a direct claim, potentially so does NAF II, the intermediate subsidiary; Gerszberg, the 100% owner of NAF; and, of course, Acquisition itself. It would be unfair for Trading to be potentially liable to four different claimants for the same damage. The claim should lie solely with the injured party, *i.e.*, Acquisition.

Further, as Judge Lynch in his concurring opinion commented:

> There 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. In settling their claims against Hampshire, the subsidiaries—and the 100% owner of both the subsidiaries and NAF—apparently concluded to accept the settlement amount in satisfaction of the obligations owed to the subsidiaries. Permitting NAF to pursue damages based on harm suffered by the subsidiaries is incongruous.

NAF Holdings, 772 F.3d at 752. As Judge Lynch pointed out, the party that was allegedly injured by the failure to consummate the merger -- Acquisition -- *has already redressed that injury* through its settlement with Hampshire, which included a release of all persons whether or not parties to the Settlement Agreement. Allowing NAF to assert a claim solely based on the injury that Acquisition sustained -- and not based on any independent, distinct injury to it where Acquisition has already been compensated for that injury to its satisfaction -- defies logic. Put another way, if Acquisition had sued Trading and settled based upon the terms of the Settlement Agreement (*i.e.*, an $830,000 payment and a release of claims), it could not reasonably be argued that NAF would have a claim against Trading for $50 million based upon what NAF now argues to be its loss of value of its investment in Acquisition.[8]

NAF's assertion that prohibiting it from making a direct claim here "would yield anomalous results within the internal structure of the laws governing derivative actions, and their intended rationales" (NAF Br. at 30) is mistaken. According to NAF, it is ordinarily the corporate defendant that asserts as an affirmative defense that a claim may only be brought

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[8] NAF asserts that the Settlement Agreement is irrelevant to the certified question here. (NAF Br. at 6). In fact, however, the Settlement Agreement is relevant, as it demonstrates the problems that may arise if a parent corporation is permitted to sue for damages incurred directly by its subsidiary.

derivatively and not directly. (*Id.*) The authority on which NAF relies, however, does not stand for that proposition. (NAF Br. at 30 n.12.) Instead, it refers to a defense that a derivative claim is improper where the shareholder bringing it failed to comply with preconditions for such claim (*e.g.*, by failing to make a demand for the corporation to sue); it states further that allowing third parties to bring that defense fosters the purpose of assuring that the board of directors makes the determination, where appropriate, whether to bring a claim on behalf of the corporation. It does not state anything about the shareholder's ability to bring a direct claim. Nor does it discuss the defense, at issue here, that a shareholder does not have legal standing directly to bring a claim belonging to the corporation.

In any event, the NAF-advocated policy "to provide the corporate defendant an opportunity to address the wrong and control the litigation" (NAF Br. at 30) is only fostered - not hindered - by the application of the *Tooley* test. That test itself demonstrates that an important purpose of the direct/derivative distinction is to require that claims only be asserted by parties that have suffered direct, independent injury. *See Tooley*, 845 A.2d at 1035. Here, the entity that was allegedly directly injured was Acquisition, not NAF. Moreover, Acquisition has addressed the alleged wrong by entering the Settlement Agreement and releasing all persons.

d. NAF's Reliance On The Hypotheticals Discussed By The Second Circuit Is Misplaced

NAF's reliance on the Second Circuit's hypothetical concerning a minority stockholder securing contract benefits from a third-party that would assist the corporation (NAF Br. at 14) does not support modifying *Tooley*. If a stockholder does obtain a commitment from a third-party to help the corporation and the third-party does not honor the commitment, it makes sense that only the *damaged* party (*i.e.*, the corporation) may sue. To hold otherwise would essentially allow a particular shareholder to have a right to specific assets of the corporation. That is contrary to Delaware law. *See Sagarra Inversiones, S.L. v. Cementos Portland Valderrivas, S.A.*, 34 A.3d 1074, 1080 n.13 (Del. 2011); *Caravel Acad. v. Campbell*, 1984 WL 19471, at *1 (Del. Ch. Mar. 27, 1984) (holding that a minority stockholder has no right to inspect a corporation's assets at will).

Nor does the Agent/Club/Performer hypothetical posited by the Second Circuit and relied on by NAF (NAF Br. at 26-27) support a direct claim here. Under that hypothetical, an Agent contracted with a Club to arrange a series of performances by a Performer, and Performer contracted with the Agent to pay 25% of its fee to Agent. Club then breached the contract by failing to book Performer. The hypothetical, however, is different from the instant case. In the hypothetical, Agent was entitled,

pursuant to its contract with performer, to a separate fee. When Club repudiated, Agent lost that fee and suffered a distinct, individual injury. Conversely, NAF has no contractual right to the assets of its wholly-owned Subsidiaries. Rather, NAF's damage claim rests entirely on the purported damages to the NAF Subsidiaries.

3. The Application of *Tooley* Here Is Consistent With Established Delaware Law

The application of *Tooley* here does not conflict with Delaware law principles. (*See* NAF Br. at 24-32). To the contrary, applying *Tooley* here to dismiss NAF's direct claim is supported by other well-established principles of Delaware law.

First, Delaware contract law provides that a plaintiff in a suit for breach of contract must prove damages to the plaintiff resulting from a contractual breach. *See VLIW Tech., LLC v. Hewlett-Packard Co.*, 840 A.2d 606, 612 (Del. 2003) (noting that in order to "state a breach of contract claim, [a] plaintiff must [plead facts sufficient to] demonstrate . . . damage to *the plaintiff*") (emphasis added); *see also Lorenzetti v. Hodges*, 62 A.3d 1224, at *3 (Del. 2013) (Table); *Eurofins Panlabs, Inc. v. Ricerca Biosciences, LLC*, 2014 WL 2457515, at *7 (Del. Ch. May 30, 2014); *Universal Enter. Grp., L.P. v. Duncan Petroleum Corp.*, 2013 WL 3353743,

at *17 (Del. Ch. July 1, 2013). Here the damage was to Acquisition; there was no independent damage to NAF.[9]

Second, under Delaware law and that of other jurisdictions, a plaintiff must have legal standing to bring a claim. Standing, in turn, requires injury. As explained by the United States Supreme Court:

> [A]t an irreducible minimum, Art. III [of the U.S. Constitution] requires the party who invokes the court's authority to show that he *personally has suffered some actual or threatened injury* as a result of the putatively illegal conduct of the defendant, and that the injury fairly can be traced to the challenged action and is likely to be redressed by a favorable decision.

Valley Forge Christian College v. Americans United for Separation of Church and State, Inc., 454 U.S. 464, 472 (1982) (emphasis added) (citations and quotation marks omitted). Thus, in order to assert its legal standing, plaintiff must demonstrate that it has suffered a personal injury and that the injury can be fairly traced to the breach. Injury is an indispensable element of legal standing, regardless of the origin and nature of the claim.[10]

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[9] Nor is it incongruous that a parent cannot sue directly for damages incurred by its subsidiary even though the counterparty may sue the parent for breach of contract. (NAF Br. at 28). The elements of a breach of contract are the same in either case and in either case damages must be shown. If the damages are to the subsidiary it is the subsidiary, not the parent, who should be permitted to bring suit (as a third-party beneficiary).

[10] As one commentator articulated aptly:

> The direct/derivative distinction is a question of standing, and standing is a matter of injury. The role of injury in standing is doctrinally fundamental,

Here NAF sustained no direct injury so it lacks standing to bring its direct claim.

Third, finding that NAF has no direct claim for damages sustained by its subsidiary is consistent with the well-established principle of the separate identity of the corporation from its shareholders, *Cargill, Inc. v. JWH Special Circumstance LLC*, 959 A.2d 1096, 1109 (Del. Ch. 2008), as well as the corollary principle that a parent corporation may not pierce the corporate veil set up for its own benefit. *See Johnson & Johnson v. Coopervision, Inc.*, 720 F. Supp. 1116 (D. Del. 1989) (a corporation that has established a subsidiary was not permitted to claim that the subsidiary was merely an alter ego of its creator in order to defeat a contention that the subsidiary was a necessary party to a lawsuit). The *Johnson & Johnson* court reasoned:

> [T]he so-called alter ego or veil-piercing doctrine is typically employed by claimants against a defendant corporation as a vehicle for holding the corporation's shareholders or its parent company liable. In the case at bar, Johnson & Johnson is postured as a plaintiff. . . . [I]t would . . . be highly unusual, if not unprecedented, for Johnson & Johnson to invoke the alter ego doctrine as a means of benefitting from its own inattention to corporate formalities. *Johnson & Johnson chose to structure its affairs as it did -- namely, with operating subsidiaries as*

> whether the context is the loftiest constitutional matters or prosaic questions of "good fences make good neighbors."

Daniel S. Kleinberger, *Direct Versus Derivative and the Law of Limited Liability Companies*, 58 BAYLOR L. REV. 63, 91 (2006).

> *distinct legal entities. It cannot now pretend that these separate entities are in fact one.*

Id. at 1126 (emphasis added); *see also Boise Cascade Corp. v. Wheeler*, 419 F. Supp. 98, 102 (S.D.N.Y. 1976), *aff'd without opinion*, 556 F.2d 554 (2d Cir. 1977).

As the Second Circuit aptly recognized in *In re Beck Industries, Inc.*, 479 F.2d 410, 418 (2d Cir. 1993), a parent corporation cannot create a subsidiary corporation and then ignore the separate corporate existence of that subsidiary whenever doing so would be advantageous:

> Where a parent corporation desires the legal benefits to be derived from organization of a subsidiary that will function separately and autonomously in the conduct of its own distinct business, the parent must accept the legal consequences, including its inability later to treat the subsidiary as its alter ego because of certain advantages that might thereby be gained. In short, the parent cannot "have it both ways."

Id.

Here, NAF is attempting to "have it both ways." NAF wants to honor corporate separateness by pointing out that only the NAF Subsidiaries and Gerszberg, not NAF, are barred by the Settlement Agreement from bringing suit, yet it wants to disregard corporate separateness by allowing the parent

(NAF) to collect damages for harm allegedly done to the NAF Subsidiaries.[11]

Fourth, NAF's injuries flow solely from the diminution in value of the NAF Subsidiaries' shares. Delaware courts have consistently held that a diminution of the subsidiary's stock value creates a derivative, and not a direct, claim. *See*, *e.g.*, *Feldman*, 951 A.2d at 735; *see also Kramer v. W. Pac. Indus., Inc.*, 546 A.2d 348, 353 (Del. 1988) ("Delaware courts have long recognized that actions charging "mismanagement which depress . . . the value of stock [allege] a wrong to the corporation; *i.e.*, the stockholders collectively, to be enforced by a derivative action"); *see also Hartsel v. Vanguard Grp., Inc.*, 2011 WL 2421003, at *18 n.120 (Del. Ch. June 15, 2011) (collecting cases), *aff'd*, 38 A.3d 1254 (Del. 2012).[12]

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[11] Similarly, Delaware law makes clear that a parent does not have any rights to the assets, including any claims, owned by the subsidiary. *See Sagarra*, 34 A.3d at 1080 n.13.

[12] Notably, courts outside of Delaware adhere to the same rule. *See*, *e.g.*, *In re Enron Corp. Sec., Derivative & "ERISA" Litig.*, 2007 WL 789141, at *14 (S.D. Tex. Mar. 12, 2007) (claims by holders of Enron securities were derivative under Delaware law because they sought recovery based on "diminution in value" of Enron securities "allegedly caused by misrepresentations of Enron's financial condition"); *see also Brister v. Schlinger Found.*, 469 F. Supp. 2d 371, 374-75 (E.D. La. 2007) (applying similar Nevada law and holding that "diminution in the value of shares is quintessentially a derivative claim") (quoting *Higgins v. NYSE*, 806 N.Y.S.2d 339, 349 (N.Y. Sup. 2005)).

Fifth, NAF's suggestion that the application of *Tooley* here would conflict with the law of contracts as it relates to third-party beneficiaries is mistaken. NAF argues that in the third-party beneficiary context both the promisee and the third-party beneficiary may sue. (NAF Br. at 24-30).

The Second Circuit did cite 13 Williston on Contracts § 37:55 (4th ed.) for the proposition that, "[d]espite the apparent difficulties caused by the promisor being potentially liable to two parties, most courts have found it simpler to allow both the promisee and the beneficiary to sue the promisor to enforce the third-party beneficiary contract." *NAF Holdings,* 772 F.3d at 747. This principle, however, supports a promisee's right to specifically enforce a contract, not its right to recover for damages incurred by a third-party beneficiary. Indeed, the same treatise provides that a promisee in this context often has standing to seek specific performance precisely "because the promisee's money-damage remedy at law is inadequate because the principal person injured by the breach of such third-party contract is usually the third-party donee-beneficiary." 25 Williston on Contracts § 67:112 (4th ed.). Contrary to NAF's position, "[b]lack letter law precludes a promisee to a contract from obtaining a judgment on behalf of a third party beneficiary for anything other than specific performance." *Wilson v. Hayes*, 77 A.3d

392, 407 (D.C. 2013); *see also Hawkins v. Gilbo*, 663 A.2d 9, 11 (Me. 1995); *Williams v. Habul*, 724 S.E.2d 104, 110 (N.C. Ct. App. 2012).

The requirement in *Tooley* for "direct injury" only prevents a promisee-shareholder who did not suffer separate injury from recovering -- directly -- damages that belong to the corporation. The rule articulated in *Tooley* does not preclude a promisee-shareholder from seeking to specifically enforce its contract. (*Cf. Bennett v. Breuil Petroleum Corp.*, 99 A.2d 236, 281 (Del. Ch. 1953) (plaintiff allowed to claim directly that stock was issued for improper purposes but not that it was issued for insufficient consideration because the latter constituted a "direct injury to the Corporation"). Put another way: "[a] promisee cannot recover damages suffered by the beneficiary, but the promisee is a proper party to sue for specific performance…." Restatement (Second) of Contracts § 307 (1981); *see also* 17B C.J.S Contracts § 843 (same).[13]

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[13] NAF argues that a rule of law barring its direct claim here could result in cases where there is no intended third-party beneficiary with standing to pursue a claim and the promisee-parent corporation is also barred from bringing suit. (NAF Br. at 27). It is correct that "an 'intended' third-party beneficiary has standing to sue on the contract, but that an 'incidental' third-party beneficiary does not." *Seligman v. McVeigh*, 1983 WL 413312, at *1 (Del. Super. Aug. 17, 1983); *see also NAMA Holdings, LLC v. Related World Mkt. Ctr., LLC,* 922 A.2d 417, 434 (Del. Ch. 2007). However, in the strained hypothetical posed by NAF, in which the parent is not independently damaged by a breach and the subsidiary is not an intended third-party beneficiary, the contracting parties' choice should be respected.

4. NAF's Reliance On Out-of-State Cases Is Of No Avail

NAF cites several cases from jurisdictions outside Delaware, claiming they create a "line of precedent" showing that courts "routinely" recognize that shareholders have standing to bring direct claims in circumstances analogous to those here. (NAF Br. at 16). These cases are not binding on this Court and lend no support for NAF's position. Rather than establishing a "line of precedent", the cases represent an array of different courts applying different tests to address whether a claim is "direct". NAF appears to refer to them in the hope that the Court will adopt its "case by case" approach, but instead of compelling adoption of a case-by-case approach, the cases cited by NAF demonstrate the benefits of the applying the clear, well-defined *Tooley* test.

For example, *Krier v. Vilione,* 766 N.W.2d 517 (Wis. 2009), actually supports the application of *Tooley* here. There, the court found that plaintiff did *not* have a direct claim because the shareholder's "right of recovery would have to be as a shareholder of [the company], not in his own stead or as another affected entity." *Id.* at 527. Similarly, in *Dinuro Investments, LLC v. Camacho*, 141 So.3d 731, 740 (Fla. Dist. Ct. App. 2014), also cited by NAF (NAF Br. at 15), the Court found no direct claim where the sole

damages sought was the "devaluation" of plaintiff's investment in its corporation.

Two other cases cited by NAF are factually distinct because the respective shareholder-plaintiffs had direct claims grounded upon injuries that were *independent* from the injuries suffered by their corporations. *Delgadillo v. White*, 2008 WL 4095494, at *3 (Ariz. Ct. App. Apr. 22, 2008) (plaintiff's claim "stems not only from a loss of value to the corporation . . . but also for [sic] the lost opportunity to purchase the property."); *Grill v. Aversa,* 2014 WL 4672461, at *7 (M.D. Pa. Sep. 18, 2014) (holding that the gist of plaintiff's claim was a direct claim of minority shareholder oppression, where any allegation of corporate injury was "merely incidental to the minority shareholder oppression claims").

Four other cases on which NAF relies: *Hikita v. Nichiro Gyogyo Kaisha, Ltd*., 713 P.2d 1197 (Alaska 1986); *Chambrella v. Rutledge*, 740 P.2d 1008 (Haw. 1987); *Pointe San Diego Residential Community, L.P. v. W.W.I. Properties, L.L.C.*, 2007 WL 1991205 (Cal. Ct. App. Jul. 11, 2007); *Unzipped Apparel, LLC v. Sweet Sportswear, LLC*, 2010 WL 2677441 (Cal. Ct. App. Aug. 4, 2010) are also from jurisdictions outside Delaware. The cases from Alaska and Hawaii are pre-*Tooley*, and the two California cases cited by NAF are unpublished and, under California Rules of Court, Rule

8.1115, have no precedential value even in California. Moreover, California applies a test similar to *Tooley*. *See Schuster v. Gardner*, 25 Cal. Rptr. 3d 468, 473 (Cal. Ct. App. 2005) (finding under both California and Delaware (*Tooley*) law, a shareholder could not bring a direct claim for the decrease in value of his stock).

NAF also seeks to rely on four cases from New York: *Inn Chu Trading Co. v. Sara Lee Corp.*, 810 F.Supp 501 (S.D.N.Y. 1992); *General Rubber Co. v. Benedict*, 109 N.E. 96 (N.Y. 1915); *In re First Cent. Financial Corp.*, 269 B.R. 502 (E.D.N.Y. 2001); and *Lawrence Ins. Grp. v. KPMG Peat Marwick*, 5 A.D.3d 918 (N.Y. App. Div. 3d Dept. 2004). These cases are distinguishable from the instant case because they do not involve a situation, like here, in which a parent sues for damages incurred by its subsidiary, where the subsidiary has been compensated to its satisfaction for the alleged damage it incurred. In any event, these cases pre-date *Tooley* and more recently the New York courts have expressly adopted the *Tooley* standard. *See Serino v. Lipper*, 123 A.D.3d 34 (N.Y. App. Div. 1st Dept. 2014); *Yuddell v. Gilbert*, 99 A.D. 3d 110 (N.Y. App. Div. 1st Dept. 2012).

Two recent New York cases closely analogous to this case have declined to find a direct claim where a shareholder did not suffer a separate

injury. *See*, *e.g.*, Serino, 123 A.D. 3d at 41; *Baccash v. Sayegh*, 53 A.D.3d 636 (N.Y. App. Div. 2d Dept. 2008).

In *Serino v. Lipper*, plaintiff sued his accountants, who were also his companies' accountants for, among other things, malpractice and breach of contract based on the accountants' alleged failure to properly value certain securities in the company's portfolio. 123 A.D. 3d at 40. Like the instant case, the issues in *Serino* did not involve typical internal corporate disputes; rather, the claims arose from a contractual relationship with third parties, *i.e.*, the company's and plaintiff's accountants, and alleged defective performance -- malpractice -- by the accountants. There, like here, the plaintiff sought damage based upon the lost value of his shares in his company. The court in *Serino*, applying *Tooley*, held that while plaintiff had established an independent duty owed to him, because his damage was the lost value of his shares, his claim was derivative. *Id.* at 41. The same reasoning applies here.

Baccash v. Sayegh is also instructive as it emphasizes how much weight modern courts attribute to the principle of corporate identity. In *Baccash*, plaintiff, the sole shareholder of Bridal Couture, Inc. ("BCI"), brought a legal malpractice claim against an attorney hired by Baccash to service BCI's acquisition of another entity. 53 A.D.3d at 636. Despite her

direct contractual relationship with the attorney, Baccash was found to not have a direct claim because she did not suffer any direct damages as a result of the attorney's deficient representation. *Id.* at 639-40. Although Baccash claimed that her losses were personal, the court found that all losses were paid exclusively from corporate coffers of her wholly-owned company, BCI. *Id.* at 639. The court reasoned:

> Although it is undisputed that the plaintiff is [BCI's] sole officer and shareholder, a corporation has a separate legal existence from its shareholders even when the corporation is wholly owned by a single individual.

Id.

Here, similarly, NAF is asking the Court to disregard the corporate identity of the NAF Subsidiaries that it has itself established. The law does not countenance such a result.

CONCLUSION

In light of the foregoing, Trading respectfully submits that this Court should advise the Second Circuit that this Court declines to modify the *Tooley* test and that under Delaware law, a promisee to a contract may not bring a direct claim for damages against a promisor for failure to provide consideration to a third party beneficiary, when the third-party beneficiary 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.

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