IN THE SUPREME COURT OF THE STATE OF DELAWARE

CITIGROUP INC., CHARLES PRINCE, VIKRAM PANDIT, GARY CRITTENDEN, ROBERT RUBIN, ROBERT DRUSKIN, THOMAS G. MAHERAS, MICHAEL STUART KLEIN, DAVID C. BUSHNELL,

Defendants Below, Appellants,

v.

AHW INVESTMENT PARTNERSHIP, MFS, INC., ANGELA H. WILLIAMS, as Trustee of the Angela H. Williams Grantor Retained Annuity Trust UAD March 24, 2006, the Angela Williams Grantor Retained Annuity Trust UAD April 17, 2006, the Angela Williams Grantor Retained Annuity Trust UAD May 9, 2006, the Angela Williams Grantor Retained Annuity Trust UAD November 1, 2007, the Angela Williams Grantor Retained Annuity Trust UAD May 1, 2008, the Angela Williams Grantor Retained Annuity Trust UAD July 1, 2008, and the Angela Williams Grantor Retained Annuity Trust UAD November 21, 2008,

Plaintiffs Below, Appellees.

No. 641, 2015

Certification of Question of Law from the United States Court of Appeals for the Second Circuit
C.A. Nos. 13-4488-cv(L), 13-4504-cv(XAP)

OPENING BRIEF OF APPELLANTS

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Table of Contents

Exhibits

Table of Citations

Page(s)

Cases

Statutes

Other Authorities

Nature of the Proceedings

The United States Court of Appeals for the Second Circuit has asked this Court the following question of Delaware law: "Are the claims of a plaintiff against a corporate defendant alleging damages based on the plaintiff's continuing to hold the corporation's stock in reliance on the defendant's misstatements as the stock diminished in value properly brought as direct or derivative claims?" Ex. B, at 3 (quoting Ex. A, at 25).

Such claims are derivative in nature. As these plaintiffs acknowledge, the law compels a "holder" plaintiff to disclaim any damages based on any fraudulent distortion in the price of the holder's shares. A holder plaintiff—unlike a purchaser or seller plaintiff—must seek damages based on allegations that (i) the ***undistorted*** value of the corporation declined, and (ii) the ***undistorted*** value of the holder's shares therefore declined. In this case, plaintiffs' theory is that between May 2007 and March 2009, the value of Citigroup's subprime-related assets declined; Citigroup's intrinsic value therefore declined; and the undistorted value of Citigroup shares therefore declined as well. Those allegations describe a primary harm to Citigroup and could give rise only to a derivative claim.

So-called "holder" claims are claims that a plaintiff affirmatively decided to forbear from selling securities on some specific date in reliance on misstatements. A holder typically, as here, seeks as damages the proceeds (or some portion of the proceeds) of the hypothetical sale of its securities that it allegedly forbore from consummating. The federal securities laws and the statutory and common law of many states do not recognize such holder claims at all, because, among other reasons, such claims are prone to after-the-fact fabrication and rest on unreasonably speculative theories of causation and damages.

Holder claims differ starkly from purchaser or seller claims for purposes of characterization as direct or derivative. A purchaser typically alleges that it actually paid a fraudulently inflated price in reliance on misstatements. A purchaser therefore typically seeks damages based on the difference between the inflated purchase price and an undistorted price at which the securities would have traded on the purchase date in the absence of the misstatements. Similarly, a seller typically alleges that it actually received a fraudulently understated price, and typically seeks to recover the difference between an undistorted price on the sale date and the fraudulently understated price. These harms are suffered only by such a purchaser or seller, and not by the issuer of the securities.

A fraudulent distortion in price is thus the essential foundation for the harm suffered by a purchaser or seller plaintiff. But as plaintiffs here admit, a holder cannot recover the amount of any such fraudulent distortion. Although a holder typically seeks to recover fictitious "proceeds" from a hypothetical sale that it forbore from consummating, it must exclude from those "proceeds" any portion of the share price that reflected fraudulent inflation. That is so because, among other reasons, a holder is not entitled to damages on the theory that it lost the opportunity to profit from a fraud by selling at a fraudulently inflated price. Instead, a holder—like plaintiffs here—typically seeks damages based on a decline in the ***undistorted*** value of its shares, which necessarily reflects a decline in the value of the underlying corporation.

In this case, plaintiffs acquired Citigroup stock in transactions not alleged to have involved any fraud. Plaintiffs were owners of Citigroup stock in May 2007, when the stock price peaked at approximately $55 per share. The price of Citigroup stock then entered a period of steep decline that coincided with the onset of the Great Recession. Plaintiffs sold the 16.6 million shares of Citigroup stock at issue here in March 2009 at a price of $3.09 per share.

In December 2010, plaintiffs sued Citigroup and certain former Citigroup directors and officers in the Southern District of New York. Plaintiffs alleged that Citigroup's disclosures in May 2007 (and at various other times) understated Citigroup's exposure to assets related to subprime mortgages. According to the complaint, if these alleged misrepresentations had been corrected, plaintiffs would hypothetically have sold 16.6 million shares of Citigroup stock. Plaintiffs seek damages based on an alleged hypothetical sale in May 2007. In

May 2007, Citigroup shares traded at about $55. Allegedly $3.41 of that price represented fraudulent inflation caused by the misrepresentations. If those misrepresentations had been corrected, Citigroup's shares would allegedly have traded in May 2007 at an undistorted value of $51.59.

Plaintiffs' primary damages theory seeks a per-share award of the difference between (1) $51.59 (the alleged undistorted share value at the time of plaintiffs' hypothetical sale in May 2007), and (2) $3.09 (the price at which plaintiffs really sold their shares in March 2009). Plaintiffs' theory is that during the twenty-two months between the hypothetical sale in May 2007 and the real sale in March 2009, the value of Citigroup's subprime-related assets declined; Citigroup's intrinsic value therefore declined; and the undistorted value of Citigroup shares therefore declined. That theory rests on a harm to Citigroup.

Summary of Argument

1. Under Delaware law, which the parties agree governs the direct/derivative issue, shareholders may bring holder claims for damages based on a decline in share value only in a derivative action. Such claims are derivative in nature under the two-prong test adopted in *Tooley* v. *Donaldson, Lufkin, & Jenrette, Inc.*, 845 A.2d 1031 (Del. 2004). That test asks: "Who suffered the alleged harm—the corporation or the suing stockholder individually—and who would receive the benefit of the recovery or other remedy?" *Id.* at 1035.

i. Citigroup suffered the relevant harm, which was a decline in the undistorted value of Citigroup itself and Citigroup shares between the date on which plaintiffs hypothetically would have sold (May 2007) and the date on which plaintiffs actually sold (March 2009). Plaintiffs seek damages based on an alleged per-share decline in undistorted value from $51.59 in May 2007 to $3.09 in March 2009. The fact that plaintiffs purport to allege reliance on misrepresentations does not change the nature of this harm. Standing to assert disclosure claims depends upon the harm alleged. Disclosure claims are derivative in nature when the harm alleged is that the corporation declined in value while plaintiff was a shareholder.[1]

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[1] *See In re J.P. Morgan Chase & Co. S'holder Litig.*, 906 A.2d 808, 818 (Del. Ch. 2005), *aff'd*, 906 A.2d 766 (Del. 2006); *Manzo* v. *Rite Aid Corp.*, 2002 WL 31926606, at *5 (Del. Ch.

The derivative nature of plaintiffs' claims is confirmed by plaintiffs' failure to satisfy *Tooley*'s direct harm test. That test, incorporated into *Tooley*'s first prong, requires that "the injury to the stockholders must be 'independent of any injury to the corporation.'" *Tooley*, 845 A.2d at 1038 (quoting *Parnes* v. *Bally Entm't Corp*., 722 A.2d 1243, 1245 (Del. 1999)). In other words, to bring a direct claim, the shareholder "must demonstrate that . . . he or she can prevail without showing an injury to the corporation." *Id*. at 1039. The Second Circuit correctly recognized that plaintiffs fail this test, but suggested that this test might be thought to "revive the 'special injury' requirement." Ex. A, at 14-20. That suggestion confuses two distinct tests. The direct harm test asks whether plaintiff has alleged injury independent *of the corporation*; the special injury test asked whether plaintiff has alleged injury not suffered *by other shareholders*. *Tooley* abolished the special injury test and reaffirmed the direct harm test.

ii. Citigroup should receive the benefit of any recovery.

The harm underlying plaintiffs' allegations is that Citigroup's subprime-related assets lost value. Plaintiffs also allege that this loss of asset value occurred because Citigroup's directors and officers mismanaged the relevant business risks. Such allegations are routinely litigated in derivative actions. In fact, derivative

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Dec. 19, 2002), *aff'd*, 2003 WL 21262118 (Del. May 29, 2003); *Malone* v. *Brincat*, 722 A.2d 5, 14 (Del. 1998).

actions based on allegations that are materially indistinguishable from those of plaintiffs here were brought against Citigroup's directors and officers and were dismissed for failure to allege demand futility adequately.

2. This Court's decision in *NAF Holdings, LLC* v. *Li & Fung (Trading) Ltd.*, 118 A.3d 175 (Del. 2015), does not permit plaintiffs to escape the *Tooley* test. *NAF* held that a promisee could bring a direct claim against a promisor for breach of a commercial contract, even though the promisee's alleged injury depended on harm suffered by corporations in which the promisee was a shareholder. In holding that the *Tooley* test did not apply to such a claim, the *NAF* Court relied on the importance of protecting freedom of contract and the enforceability of contracts. That consent-based rationale has no application to the tort claims at issue here. Whether plaintiffs' claims are direct or derivative in nature is therefore governed by the *Tooley* test.

Statement of Facts

A. Plaintiffs Acquire Citigroup Stock

In 1989, nonparty Arthur L. Williams acquired stock in Travelers Group Inc. Ex. A, at 4. In 1998, Travelers and Citicorp, which were both Delaware corporations, merged. After the merger, Mr. Williams owned 17.6 million shares of Citigroup stock, which then traded at $35 per share. *Id*.

Through transactions not described in the Complaint, Mr. Williams's Citigroup shares were transferred to the plaintiff entities. *Id*.; A16-18 ¶¶ 13-16, 27-29.[2] The plaintiff entities are controlled by Mr. and Mrs. Williams and were created for tax, estate, and investment-planning purposes. Ex. A, at 4. "By the beginning of 2007," plaintiffs held the shares at issue in this case. A13 ¶ 3. The Complaint does not allege that either plaintiffs or Mr. Williams paid a purchase price artificially inflated by any misstatement. *See AHW Inv. P'ship* v. *Citigroup Inc.*, 980 F. Supp. 2d 510, 515 (S.D.N.Y. 2013).

B. Plaintiffs' Alleged Plan to Sell

As of 2006, Mr. and Mrs. Williams had received "numerous recommendations from their Financial Advisors to sell their Citigroup stock and

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[2] The Amended Complaint (hereinafter the "Complaint") is included as pages A12 through A94 of the Appendix. The Second Circuit contemplated that the "factual setting for addressing" the certified question would encompass the allegations of the Complaint. Ex. A, at 25.

diversify their investments." A61-62 ¶ 190; *see also* Ex. A, at 4. Allegedly as a result, they "initiated a plan to sell their shares of Citigroup." A61-62 ¶ 190. The Complaint does not describe the terms or content of any such plan. *See AHW*, 980 F. Supp. 2d at 526.

Mr. Williams did cause plaintiffs to sell approximately 1 million shares of Citigroup stock at $55 per share on May 17, 2007. Ex. A, at 5; A55 ¶ 170; A65-66 ¶ 203. This sale was allegedly a "preparatory step[ ]" towards liquidation of plaintiffs' entire position. A55 ¶ 170. The Complaint does not indicate when plaintiffs' supposed plan to sell was "cancelled," as plaintiffs allege. *See AHW*, 980 F. Supp. 2d at 526; *see also* A55 ¶ 170; A67-70 ¶¶ 206-07, 209-11 (indicating cancellation occurred after events on May 17, 2007, in June 2007, and on July 20, 2007). In any event, plaintiffs do not seek damages based on hypothetical trading according to the allegedly canceled "plan." Rather, plaintiffs seek damages based on a single hypothetical sale on May 17, 2007. *AHW*, 980 F. Supp. 2d at 516, 526; A70 ¶ 213.

C. Plaintiffs' Hypothetical Sale on May 17, 2007

Plaintiffs have asserted that "had Williams received truthful and accurate information from Citigroup, he would have sold his entire position on May 17, 2007." Ex. A, at 6. This allegation does not purport to describe any actual decision considered or made by Mr. Williams. It instead purports to hypothesize, more than three and a half years after the fact, what Mr. Williams would have decided to do under counterfactual conditions.[3]

D. Citigroup's Stock Price Decline Between May 2007 and March 2009

Plaintiffs actually sold their remaining 16.6 million shares on March 18, 2009, at $3.09 per share. *Id.*; A82 ¶ 250. Between the hypothetical sale date and the actual sale date, the price of Citigroup shares declined from $55 to $3.09. Ex. A, at 5-6. According to plaintiffs, the undistorted value of a Citigroup share on the hypothetical sale date was not the trading price of $55, but was instead $51.59. *Id*. at 6 n.2; A70 ¶ 213. Allegedly the trading price had been fraudulently inflated by misrepresentations concerning Citigroup's subprime-related assets. *Id.* Citigroup's stock-price drop between May 17, 2007, and March 18, 2009, allegedly represents the combined effect of (i) the dissipation of $3.41 per share of artificial inflation and (ii) a decline of $48.50 per share in the undistorted value of Citigroup. *See id.*

The Complaint does not purport to set forth the many causes of the decline plaintiffs allege in the undistorted value of Citigroup shares from $51.91 to $3.09 over this period of twenty-two months, which coincided with the onset of the

[3] Allegedly Mr. Williams also "'considered'" selling in December 2007, on August 28, 2008, and on December 2, 2008. Ex. A, at 6 (quoting A57-58 ¶¶ 178-80). But plaintiffs do not seek damages based on any allegation that, had Citigroup's disclosures been different than they were, plaintiffs would have sold on any hypothetical sale date other than May 17, 2007.

Great Recession. Some of the decline in stock value allegedly occurred because Citigroup had been harmed by events unrelated to Citigroup's subprime-related assets. *See, e.g.*, A78-79 ¶¶ 236-37 (alleging that the loss of Citigroup's opportunity to acquire Wachovia caused at least a $5 per share stock-price drop).

A decline in the value of Citigroup's subprime-related assets allegedly caused some portion of the loss in undistorted share value during these twenty-two months. *E.g.*, A14-15 ¶ 7; *see also* Ex. A, at 5. Mismanagement by Citigroup's managers allegedly contributed to the decline in value of Citigroup's subprime-related assets. *See, e.g.*, A39 ¶ 96 (alleging that Citigroup's managers "fail[ed] to properly monitor and manage subprime risk"); A53-54 ¶¶ 162-68 (alleging that Citigroup failed to perform proper risk assessments); A85 ¶ 264 (alleging that "management's oversight" was "'less than satisfactory'" and that management "largely ignored" the risks posed by Citigroup's mortgage business); A86 ¶ 266 (alleging that Citigroup personnel lacked the "expertise" necessary to avoid subprime losses). These mismanagement allegations echo those made in several shareholder derivative actions brought against Citigroup's directors and/or officers concerning the same subject matter.[4]

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[4] *See In re Citigroup Inc. S'holder Derivative Litig*., 964 A.2d 106, 111 (Del. Ch. 2009) (alleging derivative claims based on the alleged failure of Citigroup officers and directors "to properly monitor and manage the risks [Citigroup] faced from problems in the subprime lending market and for failing to properly disclose Citigroup's exposure to subprime assets");

E. Plaintiffs' Claimed Damages

In their Complaint, plaintiffs state "that had Citigroup truthfully disclosed its exposure to subprime assets in May 2007, the price of its shares would have dropped, and [plaintiffs] are not entitled to calculate their damages using the artificially inflated price." A70 ¶ 213. Plaintiffs therefore do not seek to recover the artificial inflation of $3.41 that was contained in the price of Citigroup shares as of May 17, 2007. *Id.* Plaintiffs instead seek per-share damages based on the difference between (1) $51.59 (the alleged ***undistorted*** share value at the time of plaintiffs' hypothetical sale on May 17, 2007), and (2) $3.09 (the price at which plaintiffs really sold their shares on March 18, 2009). *Id.*; *see* Ex. A, at 6 & n.2. This calculation yields alleged aggregate damages for plaintiffs' 16.6 million shares in excess of $800 million. A70 ¶ 213; *see* Ex. A, at 6.

Plaintiffs also propose an alternative measure of damages. The alternative measure is the difference between (i) the prevailing share price after the 1998 Travelers-Citicorp merger ($35) and (ii) the actual sale price ($3.09). A56 ¶ 173. This calculation yields per-share damages of $31.91 and alleged aggregate damages in excess of $532 million. *Id.* This alternative measure seeks the

see also In re Citigroup Inc. S'holder Derivative Litig., 788 F. Supp. 2d 211, 211 (S.D.N.Y. 2011); *Lerner* v. *Prince*, 987 N.Y.S.2d 19, 21 (App. Div. 2014).

difference between Mr. Williams's alleged acquisition price and plaintiffs' sales price. Plaintiffs do not allege that either of those prices was affected by any fraud.

Because both measures are based on an alleged decline in the undistorted value of Citigroup and Citigroup shares, subsequent discussion of plaintiffs' damages will refer only to the amounts claimed under plaintiffs' primary measure.

F. Procedural History

Plaintiffs sued Citigroup and several of its former directors and/or officers in the Southern District of New York for common-law fraud and negligent misrepresentation. In support of their motion to dismiss, defendants argued that (1) plaintiffs lacked standing because plaintiffs' claims are derivative in nature under Delaware law and (2) plaintiffs failed to state a claim under New York law. The district court rejected the first argument, accepted the second, and dismissed the complaint. *AHW*, 980 F. Supp. 2d at 516. On appeal, the Second Circuit certified the direct/derivative issue to this Court. Ex. A, at 25.

Argument

I. Stock-Drop Claims by Holders Are Derivative in Nature

A. Question Presented: "Are the claims of a plaintiff against a corporate defendant alleging damages based on the plaintiff's continuing to hold the corporation's stock in reliance on the defendant's misstatements as the stock diminished in value properly brought as direct or derivative claims?" Ex. B, at 3 (quoting Ex. A, at 25). Defendants contend that such claims are derivative in nature.

B. Standard of Review: This Court answers certified questions of law de novo. *Lambrecht* v. *O'Neal*, 3 A.3d 277, 281 (Del. 2010).

C. Merits:

A "holder" claim alleges that a plaintiff forbore from selling a security in reliance on misstatements. Forty years ago, the U.S. Supreme Court held that holders have no private right of action under section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"). *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 739-49 (1975). Since *Blue Chip Stamps*, most courts to have considered the issue have refused to recognize, as a substantive matter, stock-drop holder claims under state common law.[5] The reasons stated for the rejection of

[5] *See, e.g.*, *Tradex Global Master Fund SPC Ltd.* v. *Titan Capital Grp. III, LP*, 944 N.Y.S.2d 527 (App. Div. 2012) (Connecticut and New York law); *Calibre Fund, LLC* v. *BDO Seidman, LLP*, 2010 WL 4517099, at *5 (Conn. Super. Ct. Oct. 20, 2010); *Chanoff* v. *U.S.*

holder claims, as a substantive matter, include judicial conclusions that holder claims (i) involve speculative allegations concerning hypothetical transactions,[6] (ii) fail to allege "out-of-pocket" damages (as some states require),[7] and (iii) fail to allege damages proximately caused by the alleged misstatements.[8] A few states nonetheless permit some holder claims, subject to heightened standards of pleading and proof.[9]

Whether holder claims, if permitted, are direct or derivative in nature is, of course, distinct from the question of whether to permit such claims

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Surgical Corp., 857 F. Supp. 1011, 1118-19 (D. Conn. 1994) (Connecticut law), *aff'd*, 31 F.3d 66 (2d Cir. 1994) (per curiam); *Rathje* v. *Horlbeck Capital Mgmt., LLC*, 2015 WL 4732889, at *7-8 (Ill. App. Ct. Aug. 10, 2015); *Dloogatch* v. *Brincat*, 920 N.E.2d 1161 (Ill. App. Ct. 2009); *Arent* v. *Distribution Scis., Inc.*, 975 F.2d 1370, 1374 (8th Cir. 1992) (Minnesota law); *Starr Found.* v. *Am. Int'l Grp., Inc.*, 901 N.Y.S.2d 246 (App. Div. 2010); *Estate of Browne* v. *Thompson*, 727 S.E.2d 573, 576-77 (N.C. Ct. App. 2012); *Harris* v. *Wachovia Corp.*, 2011 WL 1679625, at *11-13 (N.C. Super. Ct. Feb. 23, 2011); *WM High Yield Fund* v. *O'Hanlon*, 2005 WL 6788446, at *13-14 (E.D. Pa. May 13, 2005) (Pennsylvania law); *Arnlund* v. *Deloitte & Touche LLP*, 199 F. Supp. 2d 461, 486-90 (E.D. Va. 2002) (Virginia law).

6 *See, e.g.*, *Rathje*, 2015 WL 4732889, at *7-8; *Harris*, 2011 WL 1679625, at *12; *Calibre Fund*, 2010 WL 4517099, at *5; *Starr*, 901 N.Y.S.2d at 250-52; *WM High Yield Fund*, 2005 WL 6788446, at *13-14.

7 *See, e.g.*, *Tradex*, 944 N.Y.S.2d at 528-29; *Calibre Fund*, 2010 WL 4517099, at *5; *Starr*, 901 N.Y.S.2d at 248-49; *Chanoff*, 857 F. Supp. at 1018.

8 *See, e.g.*, *Harris*, 2011 WL 1679625, at *11-13; *Calibre Fund*, 2010 WL 4517099, at *5; *Starr*, 901 N.Y.S.2d at 249-51; *Dloogatch*, 920 N.E.2d at 1168-71; *WM High Yield Fund*, 2005 WL 6788446, at *13-14; *Arnlund*, 199 F. Supp. 2d 486-90; *Chanoff*, 857 F. Supp. at 1018-19; *Arent*, 975 F.2d at 1374.

9 *See Small* v. *Fritz Cos., Inc.*, 65 P.3d 1255 (Cal. 2003); *Holmes* v. *Grubman*, 691 S.E.2d 196, 198-200 (Ga. 2010); *Grant Thornton LLP* v. *Prospect High Income Fund*, 314 S.W.3d 913, 926-31 (Tex. 2010).

substantively. The direct/derivative issue turns on the law of the state of incorporation. Ex. A, at 9-10. Under the law of many states other than Delaware, holder claims are derivative in nature.[10] A number of courts outside of Delaware, applying Delaware law, have also held that holder claims are derivative in nature.[11]

This Court should confirm what many other courts applying Delaware law have already correctly concluded: under *Tooley*, stock-drop holder claims are derivative in nature.

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10 *See, e.g.*, *Schuster* v. *Gardner*, 25 Cal. Rptr. 3d 468, 473-76 (Cal. Ct. App. 2005) (California law); *In re WorldCom, Inc.*, 323 B.R. 844, 849-50 & n.5, 853-57 (Bankr. S.D.N.Y. 2005) (Georgia law); *Arent*, 975 F.2d at 1372-73 (Minnesota law); *Crocker* v. *Fed. Deposit Ins. Corp.*, 826 F.2d 347 (5th Cir. 1987) (Mississippi law); *Estate of Browne*, 727 S.E.2d at 575-76 (North Carolina law); *Harris*, 2011 WL 1679625, at *5-11 (North Carolina law); *In re SemCrude L.P.*, 796 F.3d 310 (3d Cir. 2015) (Oklahoma law); *Sweet* v. *Killinger* (*In re Wash. Mut., Inc. Sec., Derivative & ERISA Litig.*), 2010 WL 2803033, at *2-4 (W.D. Wash. July 15, 2010) (Oregon law); *Chinn* v. *Belfer* (*In re Enron Corp. Sec., Derivative & ERISA Litig.*), 2005 WL 2230169 (S.D. Tex. Sept. 12, 2005) (same); *Barsky* v. *Arthur Andersen, LLP*, 2002 WL 32856818 (S.D. Tex. Aug. 16, 2002) (same); *Rivers* v. *Wachovia Corp.*, 663 F.3d 610 (4th Cir. 2011) (South Carolina and North Carolina law); *Rice-Marko* v. *Wachovia Corp.*, 2010 WL 8758626 (S.C. Ct. C.P. Aug. 19, 2010) (same), *aff'd*, 728 S.E.2d 61 (S.C. Ct. App. 2012); *Am. Nat'l Ins. Co.* v. *J.P. Morgan Chase & Co.* (*In re Enron Corp. Sec., Derivative & ERISA Litig.*), 2007 WL 789141, at *14 (S.D. Tex. Mar. 12, 2007) (Texas law).

11 *See, e.g.*, *Elendow Fund, LLC* v. *Rye Inv. Mgmt.*, 588 F. App'x 27, 29 (2d Cir. 2014); *Newman* v. *Family Mgmt. Corp.*, 530 F. App'x 21, 27 & n.1 (2d Cir. 2013); *Stephenson* v. *PricewaterhouseCoopers, LLP*, 482 F. App'x 618, 621 (2d Cir. 2012); *Smith* v. *Waste Mgmt., Inc.*, 407 F.3d 381 (5th Cir. 2005); *Melgen* v. *Bank of Am. Corp.* (*In re Bank of Am. Corp. Sec., Derivative & ERISA Litig.*), 2013 WL 6504801, at *17 (S.D.N.Y. Dec. 11, 2013); *Broyles* v. *Cantor Fitzgerald & Co.*, 2013 WL 1681150, at *6-11, *13 (M.D. La. Apr. 17, 2013); *Hribar* v. *Marsh & McLennan Cos., Inc.*, 900 N.Y.S.2d 449, 451 (App. Div. 2010); *San Diego Cty. Emps. Ret. Ass'n* v. *Maounis*, 749 F. Supp. 2d 104, 127 (S.D.N.Y. 2010); *Schuster*, 25 Cal. Rptr. at 476-78; *Shirvanian* v. *DeFrates*, 161 S.W.3d 102, 110 (Tex. App. 2004).

1. Stock-Drop Claims by Holders Are Derivative in Nature Under the *Tooley* Test

Under *Tooley* v. *Donaldson, Lufkin, & Jenrette, Inc.*, 845 A.2d 1031, 1035 (Del. 2004), the direct/derivative issue in this case depends "solely" on "[w]ho suffered the alleged harm—the corporation or the suing stockholder individually—and who would receive the benefit of the recovery or other remedy?" Plaintiffs' characterization of their claim as direct is entitled to no deference. This Court must determine for itself whether plaintiffs' factual allegations state a direct or derivative claim. *See, e.g.*, *Feldman* v. *Cutaia*, 951 A.2d 727, 730, 735 (Del. 2008); *Tooley*, 845 A.2d at 1035, 1039.

i. Plaintiffs Cannot Demonstrate an Alleged Injury that Is Independent of Any Alleged Injury to Citigroup

a. The Alleged Harm Is the Decline in the Undistorted Value of Citigroup

For plaintiffs to proceed on a direct claim, "the injury to the stockholders must be 'independent of any injury to the corporation.'" *Tooley*, 845 A.2d at 1038 (quoting *Parnes* v. *Bally Entm't Corp.*, 722 A.2d 1243, 1245 (Del. 1999)). In other words, to bring a direct claim, a shareholder "must demonstrate . . . that he or she can prevail without showing an injury to the corporation." *Id.* at 1039. Subsequent opinions by this Court follow these principles. *See Feldman*, 951 A.2d at 733 (concluding that plaintiff must allege harm that was "separate and distinct from the alleged harm to the Company"); *In re J.P. Morgan Chase & Co.*

S'holder Litig., 906 A.2d 766, 770, 774 (Del. 2006) (concluding that claims were derivative where "'the damages allegedly flowing from the disclosure violation are exactly the same as those suffered by [the corporation]'" (quoting *In re J.P. Morgan Chase & Co. S'holder Litig.*, 906 A.2d 808, 825 (Del. Ch. 2005))).

Plaintiffs claim that they forbore from selling their shares in reliance on alleged misstatements concerning the extent of Citigroup's exposure to subprime assets. Their theory of recovery is that the value of Citigroup's subprime-related assets declined; that Citigroup's intrinsic value correspondingly declined; and that the undistorted value of all Citigroup shares, including plaintiffs' shares, therefore declined as well. *E.g.*, A14-15 ¶ 7, A70 ¶ 213. Under their own theory, plaintiffs do not, because they cannot, state an injury that is distinct from any injury to Citigroup. As with any decrease in the value of a company, the "shareholders at the time of the wrong . . . are harmed in a derivative sense by the wrong to the company itself." *Desimone* v. *Barrows*, 924 A.2d 908, 927 n.51 (Del. Ch. 2007). "The core of this injury is the decline in stock price, which of course reflects injury sustained by the corporation." Ex. A, at 18-19.

The Second Circuit itself acknowledged that plaintiffs' claims were likely derivative under the principles stated by this Court in *Gentile* v. *Rossette*, 906 A.2d 91 (Del. 2006), *J.P. Morgan*, 906 A.2d 808, and *Feldman*, 951 A.2d 727. Ex.

A, at 14-20.[12] The Second Circuit, however, expressed concern that these cases appeared to "revive the 'special injury' requirement" abolished by *Tooley*. *Id.* at 702. But the "special injury" test required that the plaintiff's injury not "fall[] equally upon all stockholders." *Tooley*, 845 A.2d at 1037. The problem with the special injury test, according to *Tooley*, was that it could ensnare direct claims that did not depend on harm to the corporation. *See id.* ("[The special injury test is] inaccurate because a direct, individual claim of stockholders *that does not depend on harm to the corporation* can also fall on all stockholders equally, without the claim thereby becoming a derivative claim." (emphasis added)).[13] This Court's opinions in *Gentile*, *J.P. Morgan*, and *Feldman* correctly applied *Tooley* and did

[12] *See Gentile*, 906 A.2d at 99 (dilution claims generally derivative "because any dilution in value of the corporation's stock is merely the unavoidable result (from an accounting standpoint) of the reduction in the value of the entire corporate entity"); *J.P. Morgan*, 906 A.2d at 818-19 (claim derivative because "plaintiffs, if they were harmed at all, were harmed indirectly and only because of their ownership in [J.P. Morgan]"); *Feldman*, 951 A.2d at 733 (claim derivative because plaintiffs harmed by improper payouts to executives "*pro rata* in proportion with their ownership of the corporation's stock" and "solely because they are stockholders").

[13] The facts of *Tooley* provide an example of a purported claim that was direct under the direct harm test, but arguably would have been derivative under the different and abandoned special injury test. The harm alleged in *Tooley* was a delay in the payment of cash owed to tendering shareholders pursuant to a tender offer and the resulting loss of the time value of that cash. That harm was independent of any injury to the corporation. *See Tooley*, 845 A.2d at 1033-35. But that harm was arguably not a special injury because it fell equally on all tendering shareholders and would have caused a similar delay for non-tendering shareholders. *See Tooley* v. *Donaldson, Lufkin, & Jenrette, Inc.*, 2003 WL 203060, at *3-4 (Del. Ch. Jan. 21, 2003).

not revive the special injury test.[14] Those cases correctly analyze whether a claim depends on harm to the corporation; they do not rely on the discarded special injury test, which concerned harm to other shareholders.

b. The Differences Between Holder Claims and Purchase or Sale Claims Demonstrate that Holder Claims Are Derivative

The fact that plaintiffs' holder claims depend on harm to Citigroup can be illustrated by comparing the harm underlying plaintiffs' claims with the very different harm underlying claims by purchasers and sellers.

A purchaser plaintiff typically argues that it purchased shares in reliance on a misstatement; that the misstatement fraudulently inflated the price paid by the plaintiff; and that the purchaser therefore overpaid.[15] When the truth concealed by the fraud is revealed to the market, the fraudulent inflation in the price of the shares is dissipated, and the share price typically declines.[16] A

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[14] *See also, e.g.*, *In re Tyson Foods, Inc. Consol. S'holder Litig.*, 919 A.2d 563, 601 (Del. Ch. 2007) ("For a shareholder . . . to maintain a direct claim, he or she must identify an injury that is not dependent upon injury to the corporation."); *Abraham* v. *Emerson Radio Corp.*, 901 A.2d 751, 757 (Del. Ch. 2006) ("[F]or the plaintiff to prevail on Count I, it must prove that [the company] as an entity was injured, a reality that exposes Count I as a derivative claim under the clarifying teaching of [*Tooley*].").

[15] *See, e.g.*, *Lentell* v. *Merrill Lynch & Co., Inc.*, 396 F.3d 161, 173-74 (2d Cir. 2005); *Desimone*, 924 A.2d at 927 n.51; *see also In re Activision Blizzard, Inc. Stockholder Litig.*, 124 A.3d 1025, 1056 (Del. Ch. 2015).

[16] *See, e.g.*, *Lentell*, 396 F.3d at 177.

purchaser plaintiff typically seeks as damages the amount by which the stock price was "artificially inflated" when it purchased.[17]

A seller plaintiff typically alleges that it sold shares in reliance on a misstatement, and that the misstatement caused the price received by the seller to be fraudulently understated. It typically seeks as damages the amount of the fraudulent understatement.[18] Like a purchaser's claim, a seller's claim thus depends, as an essential predicate, on a fraudulent distortion in share price.

A purported holder claim, however, necessarily rests on a completely different theory of harm and damages. Plaintiffs here have recognized that difference by disclaiming any damages based on any fraudulent distortion in the price of Citigroup shares. *See* A70 ¶ 213 (quoted *supra* p. 12). Black-letter law compelled that concession. The holder must argue that at the time of its hypothetical sale, the allegedly concealed information should have been disclosed to the entire market. If, however, disclosure to the entire market had occurred, any fraudulent inflation would have disappeared from the trading price of the security.

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17 *See, e.g.*, *Glickenhaus & Co.* v. *Household Int'l, Inc.*, 787 F.3d 408, 415 (7th Cir. 2015); 5E Arnold S. Jacobs, Disclosure and Remedies Under the Securities Laws § 20:57, at pp. 20-152 to 20-160 (2015); Daniel F. Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 Bus. Law. 1, 12 (1982).

18 *See, e.g.*, *Affiliated Ute Citizens of Utah* v. *United States*, 406 U.S. 128, 155 (1972); 5E Jacobs, *supra* n.17, at § 20:7, at p. 20-36 (noting that seller damages are the "converse" of purchaser damages).

The holder would then have been unable to sell at a fraudulently inflated price. Courts therefore do not allow holder plaintiffs to recover as damages the amount of any fraudulent inflation.[19] In addition, as a matter of public policy, a holder plaintiff is not entitled to damages on the theory that it lost the opportunity to profit from a fraud by selling at a fraudulently inflated price.[20]

Plaintiffs here therefore do not seek damages based on any fraudulent inflation. They instead base their theories of harm and damages on allegations that the value of Citigroup's subprime-related assets declined; that Citigroup's intrinsic value therefore declined; and that the undistorted value of their Citigroup shares therefore declined as well. *Supra* pp. 10-12. However denominated, a claim founded on such allegations is derivative because it is premised on harm to the corporation.

c. Disclosure Claims Are Derivative When Based on a Decline in Value of the Corporation

Plaintiffs' claims are not direct merely because they allege disclosure violations. *See* Ex. A, at 13. Disclosure violations may give rise to both direct or

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[19] *See, e.g.*, *Anderson* v. *Aon Corp.* (*Anderson II*), 674 F.3d 895, 897 (7th Cir. 2012); *Anderson* v. *Aon Corp.* (*Anderson I*), 614 F.3d 361, 367 (7th Cir. 2010); *Arent*, 975 F.2d at 1374; *Crocker*, 826 F.2d at 351; *Starr*, 901 N.Y.S.2d at 251-52; *Arnlund*, 199 F. Supp. 2d at 487-89; *Chanoff*, 857 F. Supp. at 1018.

[20] *See, e.g.*, *Anderson I*, 614 F.3d at 367; *Crocker*, 826 F.2d at 351 n.6; *Chanoff*, 857 F. Supp. at 1018 n.4.

derivative claims.[21] As with all claims, standing for disclosure claims depends upon the nature of the harm.

To be sure, some disclosure claims are, or arguably are, direct.[22] But disclosure claims in tort are derivative if the underlying economic harm is a decline in the value of the corporation. That was the case in *Malone* v. *Brincat*, which was filed as a putative class action on behalf of all persons who had owned the stock of Mercury Finance Co. over a multi-year period, during which "virtually every filing Mercury made with the SEC and every communication Mercury's directors made to the shareholders" was alleged to have overstated "earnings,

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[21] *See Malone* v. *Brincat*, 722 A.2d 5, 11-14 (Del. 1998) (nondisclosure claims are generally direct in the context of a request for shareholder action, but in the no-action context, "may result in a derivative claim on behalf of the corporation or a cause of action for damages"); *In re Tri-Star Pictures, Inc. Litig.*, 634 A.2d 319, 332 n.15 (Del. 1993) ("[W]e emphasize that the disclosure violations cannot be viewed in isolation from the defendants' total course of conduct in determining whether the plaintiffs suffered individual injury."); *see also In re Caterpillar Inc. Derivative Litig.*, 2014 WL 2587479, at *12-13 (D. Del. June 10, 2014). (holding that disclosure claim was derivative due to nature of harm alleged); *Thornton* v. *Bernard Techs., Inc.*, 2009 WL 426179, at *3 n.28, *5 (Del. Ch. Feb. 20, 2009) (holding that disclosure claims were derivative to the extent that they alleged "bad things happened" to the company, which "reflects damage to the corporation itself"); *Albajian* v. *Kennedy*, 1992 WL 8794, at *8 (Del. Ch. Jan. 17, 1992) (effects of disclosure violations on non-tendering shareholders, "whatever they may be, are derivative in nature"); *St. Clair Shores Gen. Emps. Ret. Sys.* v. *Eibeler*, 745 F. Supp. 2d 303, 313 (S.D.N.Y. 2010) (holding that, under Delaware law, a disclosure claim was derivative "because the harm for which it seeks to recover . . . is the same harm suffered by the corporation").

[22] *See Arnold* v. *Soc'y of Sav. Bancorp, Inc.*, 678 A.2d 533, 542 (Del. 1996) (claims seeking an injunction or corrective disclosure); *J.P. Morgan*, 906 A.2d at 774-775 (claims involving a "diluting transaction" "at the sole expense of the minority"); *Albert* v. *Alex. Brown Mgmt. Servs., Inc*., 2005 WL 2130607, at *7, *12 (Del. Ch. Aug. 26, 2005) (claims involving a disclosure violation that deprives the plaintiff of the ability to exercise a contractual right); *Jackson Nat'l Life Ins. Co.* v. *Kennedy*, 741 A.2d 377, 381-85 (Del. Ch. 1999) (same); *see also supra* pp. 20-21 (purchaser and seller claims).

financial performance and shareholders' equity." 722 A.2d 5, 7-8 (Del. 1998). During the period of the misstatements, the value of the company declined by about $2 billion. *Id.* at 8. Although this Court remanded to allow plaintiffs an opportunity to amend the complaint, the Court explained that an allegation referring to "the corporation losing virtually all its equity" suggested "an injury to the corporation." *Id.* at 14. To attempt to relabel such a claim as a direct claim by the shareholders "is a *non sequitur* rather than a syllogism." *Id.*[23]

Manzo v. *Rite Aid Corp*., 2002 WL 31926606, at *5-6 (Del. Ch. Dec. 19, 2002), *aff'd*, 2003 WL 21262118 (Del. May 29, 2003), correctly applied *Malone* to dismiss a stock-drop holder class action. Like *Malone* and this case, *Manzo* involved a publicly traded corporation with a large stock-price drop. Rite Aid's stock price plummeted from $50.94 in January 1999 to $2-3 in October 2000. *Id.* at *2. The *Manzo* plaintiff alleged that Rite Aid's stock price had been "artificially inflate[d]" due to misstatements in "virtually every single piece of financial information released by Rite Aid for over three years." *Id.* at *1-2. While the plaintiff claimed to have been injured by being "deprived of accurate information upon which to base investment decisions," the Court of Chancery

[23] *See Pfeiffer* v. *Toll*, 989 A.2d 683, 703 (Del Ch. 2010) ("[*Malone*] held that a corporation can pursue a cause of action for breach of fiduciary duty against officers and directors who 'deliberately misinform[ ] shareholders about the business of the corporation, either directly or by a public statement.' A corporate claim of this type may be pursued derivatively." (quoting *Malone*, 722 A.2d at 14)).

recognized that the "substance of the injury" was the harm to Rite Aid itself, which indirectly resulted in the plaintiff's receiving "a poor rate of return on her Rite Aid shares." *Id.* at *5. This Court affirmed *Manzo* "on the basis of and for the reasons set forth in" the Court of Chancery's decision. 2003 WL 21262118, at *1.[24]

A shareholder's individualized allegations of reliance do not change the nature of the injury.[25] For example, in *J.P. Morgan*, the complaint claimed that inaccurate disclosures in J.P. Morgan's proxy material induced its shareholders to approve its alleged $7 billion overpayment for Bank One. 906 A.2d at 772. Nonetheless, this Court held that "the harm resulting from the overpayment was to [J.P. Morgan]." *Id.*; *see also Feldman*, 951 A.2d at 733 ("[*J.P. Morgan*] rejected a plaintiff's effort to bootstrap the harm and damages causatively linked to a derivative claim onto what, according to that plaintiff, was an independently arising direct cause of action."). Plaintiffs' theory of damages here involves precisely this sort of "bootstrapping": they seek to combine a purportedly

[24] In accord with *Manzo*, several non-Delaware courts, applying Delaware law, have held that holder claims for breach of fiduciary duty based on disclosure violations are derivative in nature. *See, e.g.*, *Elendow*, 588 F. App'x at 29; *Melgen*, 2013 WL 6504801, at *17; *Maounis*, 749 F. Supp. 2d at 127; *Schuster*, 25 Cal. Rptr. 3d at 476-77.

[25] *Manzo* itself had involved reliance, because a nondisclosure claim for breach of fiduciary duty requires a showing of reliance, *Metro Commc'ns Corp. BVI* v. *Advanced Mobilecomm Techs. Inc.*, 854 A.2d 121, 158 & n.89 (Del. Ch. 2004), except "in connection with a request for stockholder action," *Malone*, 722 A.2d at 12.

disclosure-based theory of liability with damages resting on a primary harm to the corporation.

Moreover, plaintiffs' alleged harm and damages have, at most, an extremely attenuated connection to the alleged disclosure violations. That fact further supports the reasonableness of attributing the primary harm at issue here to Citigroup. Plaintiffs say that their damages rest on a "fraud-free" share value (A70 ¶ 213, A83 ¶ 252), which certainly suggests that those damages lack any genuine connection to the alleged disclosure fraud. And plaintiffs' damages do lack any such connection: the loss in undistorted share value after May 2007 was not knowable or reasonably foreseeable as of May 2007, when plaintiffs allegedly relied on the supposed misstatements. That is true because by definition, the alleged ***undistorted*** value of Citigroup shares at the time of plaintiffs' hypothetical sale impounded all material information and risks that Citigroup supposedly should have disclosed concerning its subprime-related assets as of that date.[26]

On the allegations of plaintiffs here, a purchaser of Citigroup shares on the date of plaintiffs' hypothetical transaction would ordinarily be entitled to

[26] *See, e.g.*, *In re El Paso Pipeline Partners, L.P. Derivative Litig.*, 2015 WL 7758609, at *44 (Del. Ch. Dec. 2, 2015) (noting that under semi-strong version of the efficient capital markets hypothesis, the market price of an investment should have reflected, to the extent of the information available, the value of a future contingency); Fischel, *supra* n.17, at 9-10.

maximum per-share damages of $3.41 (the amount of the fraudulent inflation).[27] The gross disparity between purchaser per-share damages of $3.41 and the per-share damages plaintiffs seek of $48.50 underscores the unreasonableness of attributing the harm underlying plaintiffs' damages solely to disclosure violations, as opposed to business conditions and alleged mismanagement affecting Citigroup. In any event, the harm underlying plaintiffs' damages plainly requires proof of an injury to Citigroup, whether or not that harm also has a genuine connection to the disclosure violations, as plaintiffs inaccurately contend and defendants deny. Plaintiffs' claims are therefore derivative in nature under *Tooley*.

According to plaintiffs, they can recover damages for "harm already done" to Citigroup that was allegedly concealed on the date of their hypothetical sale. Ex. A, at 13. But any disclosed harm was already reflected in the share price on that date, and any concealed harm was represented in the share price by the amount of artificial inflation. *See supra* pp. 10-12, 20-22, 26 n.26. As plaintiffs

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[27] In general, a purchaser's damages are limited to the difference between the price actually paid and the undistorted value of the security on the date of the transaction. *See, e.g.*, 5E Jacobs, *supra* n.17, at § 20:7, at p. 20-40 (Under the out-of-pocket measure of damages that is traditional in 10b-5 actions, "the evaluation [of fair value] must be made as of the time of the fraudulent transaction."); *Starr*, 901 N.Y.S.2d at 250 (holding that under New York law, damages for fraud depend on "the effect of an accurate disclosure on the price of the security at the particular time the transaction actually occurred"). *See also Poole* v. *N.V. Deli Maatschappij*, 243 A.2d 67, 73 (Del. 1968) (holding that damages in that case should be calculated on transaction date); *Gaffin* v. *Teledyne, Inc.,* 611 A.2d 467, 476 (Del. 1992) (noting same principle); *cf. Poole* v. *N.V. Deli Maatschappij*, 224 A.2d 260, 290 (Del. 1966) (noting and reserving issue).

have disclaimed inflation-related damages, they are necessarily not seeking damages for concealed harm as of the date of the hypothetical sale. In other words, plaintiffs' "fraud-free" share value as of May 2007 necessarily excludes any effect of any fraudulent concealment on the share price as of that date. *See* A70 ¶ 213, A83 ¶ 252.

ii. Citigroup Should Receive the Benefit of Any Monetary Remedy

Because Citigroup suffered the relevant harm, Citigroup should receive the benefit of any monetary recovery. *See Tooley*, 845 A.2d at 1036 (analysis under second prong "should logically follow" from the first). *Tooley*'s second prong asks whether plaintiffs "***should*** receive the benefit of any remedy." *J.P. Morgan*, 906 A.2d at 819 (emphasis added).[28] Here, plaintiffs should not. If the loss in value of Citigroup's subprime-related assets was a compensable wrong at all, which defendants deny, then it was a wrong against Citigroup, which should be the beneficiary of any recovery.

(a) Courts dismissed the derivative actions filed against Citigroup's directors and officers concerning Citigroup's subprime exposure for failure to

[28] *See also In re NYMEX S'holder Litig.*, 2009 WL 3206051, at *9 (Del. Ch. Sept. 30, 2009) (*Tooley*'s second prong asks whether "any monetary recovery would *properly belong* to the company." (emphasis added)); *Dieterich* v. *Harrer*, 857 A.2d 1017, 1028 (Del. Ch. 2004) ("[A]pplying the second prong of *Tooley* . . . any monetary recovery for the breaches of duty alleged . . . would *properly belong* to the corporation, rather than to the stockholders personally or any ill-defined subset of them." (emphasis added)).

plead demand futility. *See, e.g.*, *In re Citigroup Inc. S'holder Derivative Litig*., 964 A.2d 106, 106 (Del. Ch. 2009). But the fact that a derivative action may not be successful—because, for example, of the demand requirement, the continuous ownership requirement, the business judgment rule, or an exculpatory charter provision authorized by 8 *Del. C.* § 102(b)(7)—is not a good reason to permit a direct claim based on injury to the underlying corporation.

These limits on derivative actions are intended to restrict the circumstances in which shareholders may recover for losses to the corporation caused by alleged mismanagement or the materialization of "business risk," such as Citigroup's subprime exposure. *Citigroup Derivative Litig.*, 964 A.2d at 123 (emphasis omitted). These limits reflect a sensible policy judgment that it would "in the long-run, be injurious to investor interests" if managers were discouraged from taking risks due to the possibility of "substantive second guessing by ill-equipped judges or juries." *Id.* at 122. By allowing recovery for the same harm as derivative actions, while circumventing all of the limits applicable to derivative actions, direct stock-drop holder claims would undermine the policies that these limits promote.

(b) An important purpose of the direct/derivative distinction is to assign recovery for particular harms to either the corporation or the shareholders, but not both, so as to prevent potential double recovery by the corporation and its shareholders. *See J.P. Morgan*, 906 A.2d at 773. Distinguishing direct from derivative claims based on cause of action (e.g., breach of fiduciary duty versus other torts) or theory of liability (e.g., mismanagement versus nondisclosure) would result in a failure to achieve this purpose. After an episode of alleged corporate misconduct, various plaintiffs routinely attempt to plead derivative mismanagement claims for breach of fiduciary duty and direct holder claims alleging other torts based on nondisclosure of the mismanagement, all of which involve the same harm to the corporation. This very case, viewed together with the related derivative actions, is an example. *Tooley*'s focus on harm properly impedes artful pleading from enabling the assertion of duplicative direct and derivative actions.

(c) Two intertwined purposes of characterizing claims as derivative are "protecting the entity and all of its investors against excessive litigation" and "ensur[ing] that injury to a whole association [of equity investors] is adjudicated on behalf of that whole and not just for the benefit of the individuals who have undertaken to pursue the claims." *In re El Paso Pipeline Partners, L.P. Derivative Litig.*, 2015 WL 7758609, at *16 (Del. Ch. Dec. 2, 2015). These purposes strongly support characterizing stock-drop holder claims as derivative.

Purported holder claims are particularly likely to be abusive. *See supra* pp. 14-15 & nn.5-8.[29] Control by the board of directors is thus especially appropriate. Moreover, a holder claim against the corporation and indemnified managers is, as an economic matter, an indirect claim against all other shareholders. Those other shareholders will include "similarly situated shareholders" who held during the same stock-price drop and suffered the same derivative injury. *Smith* v. *Waste Mgmt., Inc.*, 407 F.3d 381, 385 (5th Cir. 2005).

Holder claims cannot ordinarily be brought in class actions, because (i) section 10(b) of the Exchange Act does not allow private actions by holders (*see supra* p. 14); (ii) the federal Securities Litigation and Uniform Standards Act of 1998 precludes most state-law holder class actions;[30] and (iii) reliance, among other elements, is generally viewed as raising individual issues that preclude class certification.[31] Holder claims can therefore be a vehicle for wealthy shareholders (or wealthy individuals like Mr. and Mrs. Williams who owned and controlled

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29 *See also* Jeffrey W. Apel, *Eliminating Claims that Jeopardize the Stature of America's Capital Markets*, 5 DePaul Bus. & Com. L.J. 605, 636 (2007) (noting that holder claims "are some of the most dangerous securities claims" and that their elimination "has the effect of strengthening the integrity and efficiency of the market").

30 *Merrill Lynch, Pierce, Fenner & Smith Inc.* v. *Dabit*, 547 U.S. 71, 86 (2006) (noting that holder class actions under state law would have been a "particularly troublesome subset" of class actions).

31 *See, e.g., Gaffin*, 611 A.2d at 474-75; *Dubroff* v. *Wren Holdings, LLC*, 2010 WL 3294219, at *6 (Del. Ch. Aug. 20, 2010).

shareholders) to transfer risk to smaller shareholders. All of these reasons demonstrate why holder claims should be litigated "on behalf of [the] whole [association of equity investors] and not just for the benefit of the individuals who have undertaken to pursue the claims." *In re El Paso Pipeline*, 2015 WL 7758609, at *16.

In this context, only the law of the state of incorporation can establish "reliable and efficient corporate laws," *NAF Holdings, LLC* v. *Li & Fung (Trading) Ltd.*, 118 A.3d 175, 181 (Del. 2015), that protect the control of a corporation's board of directors over litigation based on injury to the corporation. While most courts have refused to recognize stock-drop holder claims as a matter of substantive law, others do permit such claims. *See supra* pp. 14-15 & nn.5-9. Because publicly traded corporations cannot practically and reliably avoid such jurisdictions, competition between jurisdictions cannot be relied upon to establish uniform or efficient rules. *See* Michael A. Perino, *Fraud and Federalism, Preempting Private State Securities Fraud Causes of Action*, 50 Stan. L. Rev. 273, 324-26 (1998).[32] To the contrary, some states may face incentives to adopt "lax

[32] Plaintiffs argue that Florida substantive law governs their claims because Mr. and Mrs. Williams reside in Florida. Ex. A, at 7-8 & n.3. Under plaintiffs' theory, each jurisdiction's substantive decision to recognize holder claims would apply only to its own residents. The natural result would be a "race to the bottom," because each jurisdiction could deprive only its own residents of such claims. No jurisdiction, as a matter of substantive law, could uniformly prohibit such claims. *See* Perino, *supra* p. 32, at 328.

liability rules" that will benefit "[i]n-state plaintiffs," because the costs that those rules impose on the corporation and on other shareholders are "largely exported out-of-state." *Id.* at 327. Indeed, the available case law suggests that at least three of the states that permit holder claims under their substantive law would also classify such claims as derivative under their corporate law. *See supra* nn.9-10.

2. The *Tooley* Test Applies to the Tort Claims at Issue Here

After this Court's decision in *NAF*, 118 A.3d 175, plaintiffs argued that *Tooley* is applicable only to claims for breach of fiduciary duty. The Second Circuit found it "difficult to conclude that *Tooley* does not apply" here. Ex. A, at 23 n.8. The Second Circuit was right.

NAF held that a promisee could bring a direct action against a promisor for breach of a commercial contract, even though the promisee's alleged injury depended on harm suffered by corporations in which the promisee was a shareholder. 118 A.3d at 176-77. The *NAF* Court found that the *Tooley* test did not govern such a claim. *Id.* In the Court's view, to require a party to a commercial contract to satisfy the requirements for a derivative action would have undermined both Delaware's strong policy favoring "freedom of contract" and the "fundamental principle of contract law" that a party to a contract has "a right to enforce" it. *Id.* at 180-81 & nn.14-15. *NAF*'s consent-based rationale is limited to claims by promisees for breach of a commercial contract and has no application to the tort claims at issue here.

It would not make sense to suggest that *NAF* limited *Tooley* to claims for breach of fiduciary duty. Claims for breach of fiduciary duty based on nondisclosure, which *Tooley* clearly governs, are not distinguishable in any relevant way from other tort claims alleging nondisclosure, such as plaintiffs' claims for fraud and negligent misrepresentation.[33] If *Tooley* were limited to fiduciary-duty claims, plaintiffs would routinely be able to plead duplicative direct fraud claims and derivative fiduciary-duty claims for the same harm and damages. Courts outside Delaware, interpreting Delaware law, have applied *Tooley* to torts other than claims for breach of fiduciary duty.[34]

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33 *See Metro Commc'ns*, 854 A.2d at 155 (noting "substantial overlap" and "intertwining" that "should surprise no one" between fiduciary-duty claim for nondisclosure and another tort of nondisclosure).

34 *See, e.g.*, *Newman*, 530 F. App'x at 27 & n.1 (negligent misrepresentation); *Stephenson*, 482 F. App'x at 621 (negligence-based professional malpractice); *Smith*, 407 F.3d at 385 (fraud and negligent misrepresentation); *Broyles*, 2013 WL 1681150, at *6-11, *13 (fraud); *Hribar*, 900 N.Y.S.2d 449 (fraud and negligent misrepresentation); *Shirvanian*, 161 S.W.3d at 110 (fraud and negligent misrepresentation).

Conclusion

Defendants respectfully ask this Court to hold that plaintiffs' claims are derivative in nature under Delaware law.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on January 11, 2016, the foregoing was caused to be served upon the following counsel of record via *File & ServeXpress*:

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