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Delaware Insider:

Delaware Supreme Court Clarifies Divide Between Direct and Derivative Claims in Breach of Contract Actions and Demonstrates the Value of the Certified Question

By [Stephen B. Brauerman](#) and [Sara E. Bussiere](#)

The Delaware Supreme Court recently answered a certified question of Delaware law from the United States Court of Appeals for the Second Circuit pursuant to a constitutional amendment that authorizes such proceedings. The Delaware Supreme Court's authority to consider and determine questions of law posed to it from jurisdictions across the United States, including the Securities and Exchange Commission, allows the Court quickly and efficiently to decide critical legal issues as they arise, and to develop and strengthen Delaware's existing robust corporate law. The Court's recent decision in *NAF Holdings, LLC v. Li & Fung Trading Ltd.*, C.A. No. 641, 2014, 2015 WL 3896792 (Del. June 24, 2015), exemplifies this point. In *NAF Holdings*, the Delaware Supreme Court, in response to a question submitted by the Second Circuit, clarified the distinction between a direct and derivative action and held that "a suit by a party to a commercial contract to enforce its own contractual rights is not a derivative action under Delaware law," even where the only economic damage the plaintiff suffered was to the value of stock of two wholly owned subsidiaries. This article provides a brief overview of Delaware's "Certified Questions" procedures, the *NAF Holdings* decision, and its impact on the scope of direct and derivative claims brought under Delaware law.

Delaware's Constitutional Mandate

In 1983, Delaware amended its constitution to permit the Delaware Supreme Court to hear questions certified to it from other state and federal courts. In 2007, the Delaware legislature amended the Delaware Constitution to include questions certified from the Securities and Exchange Commission. To effect its constitutional mandate, the Delaware Supreme Court adopted Rule 41(b), which provides that the Court may, in its discretion, accept questions certified from eligible tribunals "only where there exist important and urgent reasons for an immediate determination by this Court." To meet Rule 41(b)'s stringent requirements, the parties may not dispute any material facts and the Court must consider whether the case involves a novel question of Delaware law, conflict in trial court decisions, or an unsettled question involving a Delaware statute or contractual provision.

Since the adoption of the "Certified Question" amendment, the Delaware Supreme Court has considered 25 certified questions and answered 23 of them. Consistent with the Court's preferences, nearly all of these certified questions originated from non-Delaware tribunals. (The Delaware Supreme Court prefers to address questions of first impression from its own courts on a fully developed record or through an interlocutory appeal.) *NAF Holdings* was no exception.

The *NAF Holdings* decision demonstrates how the Delaware Supreme Court's authority to hear questions certified to it creates efficiency by allowing for timely resolution of critical questions of Delaware law.

The NAF Decision

In *NAF Holdings*, the Second Circuit asked the Delaware Supreme Court to consider whether, under Delaware law, a plaintiff who

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?

In other words, the Second Circuit asked whether a party to a contract may enforce

its own contractual rights, even though the damages suffered by the breach of the contract it seeks to enforce occurred indirectly through the diminution of value of the stock of two subsidiaries it owns.

NAF Holdings, LLC, formed two wholly owned subsidiaries to complete its acquisition of Hampshire Group, Ltd., a public fashion apparel company. To obtain the financing necessary to complete the acquisition, NAF contracted with Li & Fung (Trading) Ltd. (“L&F Trading”) to serve as a sourcing agent. NAF’s two subsidiaries then entered into a merger agreement with Hampshire. Notably, NAF was not a party to the merger agreement. Subsequent to the entry of the merger agreement, NAF alleged that L&F Trading breached its contract, causing NAF’s funding commitments to fall through and the deal to crater. NAF filed suit against L&F Trading in the United States District Court for the Southern District of New York (the “District Court”), seeking to recover approximately \$30 million in damages resulting from the diminution in value of the stock it owned in the two subsidiaries caused by the blown deal.

L&F Trading moved for summary judgment on the New York complaint because, it argued, NAF had to bring its claim derivatively on behalf of the two subsidiaries, both of which had already released their claims in a separate settlement with Hampshire. The District Court granted the motion for summary judgment, mistakenly concluding that because L&F Trading injured NAF in its capacity as the sole owner of the subsidiaries, that NAF could not maintain a direct claim for breach of contract damages. The District Court relied on the Delaware Supreme Court’s 2004 decision in *Tooley v. Donaldson, Lufkin & Jenrette*, 845 A.2d 1031 (Del. 2004), which set forth a test for determining whether a claim is direct or derivative. In *Tooley*, the Delaware Supreme Court held that in determining whether a claim is direct or derivative, a court:

should look to the nature of the wrong and to whom the relief should go. The stockholders’ claimed direct injury must be independent of any alleged injury to the corporation.

The stockholder must demonstrate that the duty breached was owed to the stockholder and that he or she can prevail without showing an injury to the corporation.

Applying the test set forth in *Tooley*, the District Court found that NAF’s claims were not independent of its subsidiaries’ claims against L&F, and therefore, NAF’s claims should have been brought derivatively.

The District Court’s conclusion conflated direct (i.e., claims belonging to the party filing the suit) and derivative claims (i.e., claims belonging to a corporation but filed by a stockholder on behalf of the corporation because it was unwilling or unable to act). As the Delaware Supreme Court explained in *Tooley*, the distinction between direct claims and derivative claims is doctrinal and related to the nature of the relationship between shareholders and the corporation on behalf of which the derivative claim is brought:

The derivative suit has been generally described as one of the most interesting and ingenious of accountability mechanisms for large formal organizations. It enables a stockholder to bring suit on behalf of the corporation for harm done to the corporation. Because a derivative suit is being brought on behalf of the corporation, the recovery, if any, must go to the corporation. A stockholder who is directly injured, however, does retain the right to bring an individual action for injuries affecting his or her legal rights as a stockholder. Such a claim is distinct from an injury caused to the corporation alone. In such individual suits, the recovery or other relief flows directly to the stockholders, not to the corporation.

Tooley, 845 A.2d at 1036 (internal citations and quotations omitted).

Since a derivative claim is brought on behalf of the corporation, before a shareholder can bring such a suit, he or she must satisfy rigorous demand requirements. *See Rales v. Blasband*, 634 A.2d 927, 932 (Del. 1993) (“Because directors are empowered to manage, or direct the management of, the business and affairs of the corporation,

8 *Del. C.* § 141(a), the right of a stockholder to prosecute a derivative suit is limited to situations where the stockholder has demanded that the directors pursue the corporate claim and they have wrongfully refused to do so or where demand is excused because the directors are incapable of making an impartial decision regarding such litigation.”).

In answering the certified question, the Delaware Supreme Court distinguished between claims that belong to the corporation in which the stockholder invested (here the two subsidiaries) and claims that belong to the stockholder itself (NAF’s direct breach of contract claim against its contractual counterparty, L&F Trading). Neither of the subsidiaries were parties to the contract between NAF and L&F Trading (nor could they be because neither existed at the time the contract was executed) and did not have any direct rights to enforce the contract. While the damages NAF suffered as a result of L&F Trading’s alleged breach were indirect in that they resulted from the decreased value of the subsidiaries’ stock, NAF’s cause of action was still direct because it flowed from NAF’s (not its subsidiaries’) express contractual rights. As the Delaware Supreme Court explained, before applying the test articulated in *Tooley*, “a more important initial question has to be answered: does the plaintiff seek to bring a claim belonging to her personally or one belonging to the corporation itself?” If the plaintiff owns the claim, the *Tooley* test does not apply.

Reaffirming Delaware’s fundamental respect for the principles of freedom of contract and rejecting a reading of Delaware law that would apply “burdensome demand excusal process[es] before allowing [parties] to sue on their commercial contracts,” the Delaware Supreme Court answered the question certified by the Second Circuit by holding that “a suit by a party to a commercial contract to enforce its own contractual rights is not a derivative action under Delaware law.” As a result, the Delaware Supreme Court suggested that the District Court’s decision to grant L&F Trading’s motion for summary judgment was based on a misapplication of Delaware law.

Conclusion

NAF Holdings, while clarifying Delaware law on direct and derivate actions, aptly illustrates the Delaware legislature's and courts' commitment to addressing complicated issues quickly to provide certainty to Delaware companies. In *NAF Holdings*, the Delaware Supreme Court took just seven days to answer the Second Circuit's certified question. The precedential value of a prompt and final answer on an important and un-

resolved aspect of Delaware law benefits parties, judges, practitioners, and students of Delaware law. The Delaware Supreme Court's authority to consider and determine questions certified to it from state and federal courts, such as the one certified by the Second Circuit in *NAF Holdings*, has proven to be an effective method to expeditiously and efficiently decide critical legal issues while also advancing Delaware's robust corporate and commercial law.

Stephen B. Brauerman is a director and Sara E. Bussiere is an associate at Bayard P.A. in Wilmington, Delaware, where they specialize in corporate and intellectual property litigation. The views expressed herein are the authors' own, and do not necessarily represent the views of Bayard P.A. or its clients.