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## *The Delaware Supreme Court Provides Guidance to the Second Circuit Regarding Investor Holder Claims*

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On certification from the Second Circuit Court of Appeals, the Delaware Supreme Court recently addressed whether “Holder Claims”<sup>1</sup> are direct claims that can be asserted by investors against a corporation or are derivative claims that must be asserted on behalf of that corporation. The Delaware Supreme Court found that Holder Claims are direct; they “belong to the stockholder who allegedly relied on the corporation’s misstatements to her detriment.” *Citigroup Inc. v. AHW Investment Partnership*, Case No. 641, 2015, 2016 Del. LEXIS 310 (Del. May 24, 2016).

The case started in federal court in the Southern District of New York when plaintiffs sued Citigroup and its executives, seeking alleged losses of over \$800 million, because plaintiffs purportedly refrained from selling their shares of Citigroup before the Great Recession in 2009 due to alleged misrepresentations. *AHW Investment Partnership v. Citigroup Inc.*, 806 F.3d 695 (2d Cir. 2015). The Citigroup defendants allegedly failed to disclose their level of exposure to subprime mortgages, which plaintiffs say enticed them to continue to hold their investment even as the share price started to slide in 2009.<sup>2</sup> Defendants had won dismissal at the trial court level on various grounds, but when plaintiffs appealed, defendants cross-appealed and argued they should have also been granted dismissal because plaintiffs’ claims were derivative, not direct in nature.<sup>3</sup> If defendants were correct, plaintiffs—who had subsequently sold their Citigroup shares in late 2009—would have lacked standing to maintain their suit.<sup>4</sup> Given that standing is a jurisdictional question that must be answered first, the Second Circuit began its analysis of the appeal there.

The Second Circuit determined that the direct/derivative dichotomy could be answered by looking to Delaware law, which is the state of incorporation for Citigroup, and the leading case on the matter, *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031 (Del. 2004).<sup>5</sup> Under *Tooley*, a court determines whether a claim is derivative or direct by looking at: (1) “who suffered the alleged harm” (the corporation or the stockholders); and (2) “who would receive the benefit of any recovery” (same).<sup>6</sup> However, the Second Circuit took “pause” because subsequent developments in the Delaware courts suggested to the panel that *Tooley* may have been questioned in recent years.<sup>7</sup> In light of this uncertainty, the Second Circuit certified the issue<sup>8</sup> to the Delaware Supreme Court for its guidance.

The Delaware Supreme Court wasted little time answering the question—“the holder claims in this action are direct.”<sup>9</sup> But, it did so because in its view the laws of the state of New York (the forum of



the original suit and location of the stock exchange on which Citigroup's shares traded) or Florida (plaintiffs' state of residence), *not* Delaware, would allow such Holder Claims.<sup>10</sup> In the court's view, Delaware law did not apply to the dispute at all because plaintiffs had brought common law fraud and negligent misrepresentation claims.<sup>11</sup> Thus there was no part of the case that would turn on the internal affairs of Citigroup (a Delaware corporation) such that Delaware law would need to be applied.<sup>12</sup> If plaintiffs, on the other hand, had asserted a claim for breach of fiduciary duty, that would have been a completely different matter.<sup>13</sup> But, given the claims at issue, the Delaware Supreme Court explicitly held the *Tooley* two-part test did not apply—that test was “designed for determining whether fiduciary duty claims are direct or derivative” only and was never “intended to be a general statement requiring all claims ... to be brought derivatively whenever the corporation ... suffered the alleged harm.”<sup>14</sup> Since plaintiff shareholders, not Citigroup, were the holders of the stock, their claims were direct and “Delaware law cannot convert a direct claim” into a derivative one.<sup>15</sup>

Had the Delaware Supreme Court reached a contrary conclusion (i.e., Holder Claims were derivative), investors likely would have faced additional obstacles plaintiffs must address in traditional derivative litigation (e.g., plaintiffs being required to make a demand on the board of directors to bring the lawsuit or sufficiently alleging such demand would have been futile, possible business judgment defenses, continuous ownership requirements, recovery going to the company on whose behalf the litigation was brought, etc.). Additionally, it is noteworthy that the Delaware Supreme Court wrote in dicta that allowing investors in 50 different states to pursue Holder Claims like plaintiffs in the instant case against a corporation traded on one national stock exchange was a “concern.”<sup>16</sup> But the court declined to act or make any holding based on that concern given the narrow scope of the certified question.<sup>17</sup>

Following the Delaware Supreme Court's decision, the Second Circuit ordered the parties to submit letter briefing “discussing the import” of that opinion. The ramifications of this development for litigants in unrelated Holder Claims litigation thus still are unknown. But if the “concern” expressed by the Delaware Supreme Court to such claims being filed in multiple states is shared by the Second Circuit, then share “holders” may still face additional obstacles in litigation.



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<sup>1</sup> Holder Claims are claims brought by plaintiffs who allege not that they were induced to buy or sell stock, but rather that they continued to hold shares based on alleged misrepresentations or omissions and whose holdings have decreased in value over the period during which they held those shares.

<sup>2</sup> *Id.* at 697.

<sup>3</sup> *Id.* at 699.

<sup>4</sup> *Id.* at 697.

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<sup>5</sup> *AHW Investment Partnership*, 806 F.3d at 699.

<sup>6</sup> *Id.* at 700.

<sup>7</sup> *Id.* at 701. The Second Circuit noted that courts within its own borders also “cast doubt” on whether Holder Claims like plaintiffs’ should be brought directly and instead should have been “properly brought under Delaware law as derivative claims.” *Id.* at 703.

<sup>8</sup> The certified question was: “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 property brought as direct or derivative claims.” *Id.* at 705.

<sup>9</sup> *Citigroup*, 2016 Del. LEXIS 310, at \*2.

<sup>10</sup> *Id.* at \*32 – 34.

<sup>11</sup> *Id.* at \*23 – 25.

<sup>12</sup> *Id.* at \*25.

<sup>13</sup> *Id.*

<sup>14</sup> *Id.* at \*36.

<sup>15</sup> *Id.* at \*41.

<sup>16</sup> *Id.* at \*31, 42 – 43.

<sup>17</sup> *Id.* at \*31, 42 – 43.