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Minority Shareholders Should Insist on Anti-Dilution Protection

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Philip D. Amoa

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In the case of *Jacob Kasher Hindlin v. Lukasz Gottwald et al.*, case number 2019-0586, in the Chancery Court of Delaware, Plaintiff Jacob Kasher Hindlin brought an action against three former members of Core's board of managers (the Board) to recover what he believed he was owed by Core. Hindlin alleged that Defendants Lawrence Spielman, Lukasz Gottwald and Renee Karalian improperly diluted Core's minority shareholders in breach of their fiduciary duties and the covenant of good faith and fair dealing implied in the LLC agreement.

In February 2015, Spielman pitched an investment in Core to Hindlin, after which Hindlin acquired 2,000 Core units for $12,000. In connection with this initial investment, Hindlin signed a joinder binding him to the LLC agreement. In early 2017, after a second appeal from Spielman, Hindlin acquired an additional 2,000 Core units, this time for $120,000.

On October 1, 2018, Hindlin was informed that Core was being acquired by KDP for an enterprise value of $525 million (the Acquisition). The Acquisition closed in November 2018 for an adjusted price of $449,462,907, and Hindlin did not challenge the Acquisition's terms or fairness.

According to his 2017 Core K-1, Hindlin owned about .613% of Core's equity at year-end 2017. Based on this stake, Hindlin believes he should have received $2,755,207 for his units following the Acquisition. Instead, Hindlin was offered consideration totaling $393,582.89.

Hindlin alleged the discrepancy between what he was owed and what he was offered was the result of the Board's improper dilution of the company's minority unitholders.

First, he alleged the company issued some number of so-called incentive units prior to the KDP transaction. These incentive units allegedly constituted approximately 18% of the Core units exchanged for KDP shares in the Acquisition, and Hindlin alleged Core's refusal to identify to whom these units were allotted suggested their purpose was to dilute minority shareholders.

Second, Hindlin identified changes in Core's 2017 capital accounts as evidence of dilution. Core issued 271,829 units that year. If these units had been issued at the same price Hindlin paid for his units in 2017, these sales should have raised $16.3 million and the company's year-end capital should have totaled $24.6 million. Instead, the company recorded a year-end capital balance of $1.4 million.

Third, Hindlin noted that a shift in the proportion of his membership interest to capital interest allowed for an inference of dilution. In 2015 and 2016, Hindlin's membership interest was three to four times greater than his capital interest. By the end of 2017, however, his membership interest was only about 15% of his capital interest, and he alleged this must be the result of dilution.

Hindlin alleged that Defendants breached the implied covenant of good faith and fair dealing by approving the issuance of dilutive units. Defendants responded, and the court agreed, that the implied covenant was not implicated by those pled facts because the LLC agreement explicitly addressed the issuance of potentially dilutive shares; under Section 5.1(c)(iii) of the agreement, for example, the Board is empowered to issue incentive units under the company's equity incentive plan. With contractual language directly on point, there was no "gap" for the implied covenant to fill – the implied covenant cannot be employed to impose new contract terms that could have been bargained for but were not.

Moreover, given how anti-dilution clauses are common contractual provisions within the governing documents of closely held business organizations, Hindlin either could have attempted to bargain for anti-dilution protection or could have chosen not to invest in Core in the absence of this protection. Nevertheless, he did neither. Accordingly, Hindlin's attempt to invoke the implied covenant of good faith and fair dealing was rejected by the court as a matter of law, as Hindlin failed to state a claim for breach.

Hindlin also pled a breach of fiduciary duty claim against Defendants arising from the same allegedly dilutive issuance of Core units.

Defendants argued that the dilution claim was "classically derivative" and that Hindlin's standing to prosecute the claim was extinguished upon completion of the Acquisition. However, Hindlin argued that he was asserting a "dual-natured claim" as described by *Gentile v. Rossette* and that his direct claim therefore had survived the Acquisition.

To resolve the dispute, the court applied a two-part test to determine whether a claim is direct or derivative: (1) who suffered the alleged harm (the corporation or the suing stockholders individually) and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders individually).

Where all of a corporation's stockholders are harmed and would recover pro rata in proportion with their ownership of the corporation's stock solely because they are stockholders, the claim is derivative in nature. Hence, under this paradigm, the traditional rule is that dilution claims are classically derivative.

Despite Hindlin's reference to *Gentile*'s dual-natured claim, the Supreme Court clarified *Gentile* in *El Paso Pipeline GP Co*. by holding that dilution claims are dual-natured only when there is some expropriation of control, in addition to economic value, from minority stockholders. Accordingly, no such expropriation of control was alleged here.

Moreover, to state a dual-natured claim, a plaintiff must plead facts from which the court can reasonably infer an agreement or arrangement among the alleged [control] group members. A complaint fails to meet this standard if all it alleges is that a group of shareholders have "parallel interests."

The complaint here was devoid of allegations that Defendants had any such agreement, much less that a control group existed. Because Hindlin failed to adequately plead that his breach of fiduciary duty claim was dual-natured under *Gentile*, the court determined that it was proper to characterize the claim as classically derivative. Accordingly, Hindlin lost his standing to prosecute his dilution-based breach of fiduciary claims upon consummation of the Acquisition, and the court further dismissed Count II of Hindlin's complaint. Accordingly, the court granted Defendants' motion to dismiss Hindlin's overall complaint.

**This article was written with assistance from our 2020 summer associate Steve Greco.*