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IN THE COURTS

Delaware Supreme Court Clarifies Standard for Liability for Disclosure Violations

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In *Dohmen v. Goodman*,[1] the Delaware Supreme Court, in response to a certified question of law from the US Court of Appeals for the Ninth Circuit, provided significant guidance regarding the showing required for a plaintiff to seek compensatory damages for claims arising out of alleged disclosure violations. The Court distinguished between claims for a breach of the fiduciary duty of disclosure—which occur in situations in which the board makes a material misrepresentation or omits a material fact when seeking action from stockholders generally—and claims for breach of fiduciary duty that occur where the directors communicate with stockholders outside of the context of a request for stockholder action and knowingly disseminate false information. The Court confirmed that violations of the fiduciary duty of disclosure may give rise to damages liability per se, but that the per se rule presumes only nominal damages. The Court also confirmed that, in cases where the disclosure violation occurs outside of a request for action by stockholders generally, the per se rule does not apply, and that a plaintiff must demonstrate that a fiduciary acted with scienter—that is, knowingly disclosed false information—to state a claim for breach of fiduciary duty. In either case, to receive an award of compensatory damages, a plaintiff must satisfy its burden to prove reliance and causation.

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Background

In 2010, defendant Bert Dohmen decided to launch a hedge fund, forming the Croesus Fund, L.P., a Delaware limited partnership (Fund), and establishing Macro Wave Management, LLC, a Delaware limited liability company, to act as its general partner.[2] Dohmen was the sole member and manager of the general partner, which had exclusive control over the Fund. In 2011, Dohmen sought an investment from plaintiff Albert Goodman, who on November 14, 2011, made an initial investment of $500,000 in the Fund (First Investment).[3]

After making the First Investment, Goodman asked Dohmen about other investors that would be participating in the Fund.[4] Dohmen responded:

"'There are several other close friends I told about the fund that are now liquidating assets in order to participate.'"[5] That statement was not accurate—and Dohmen was aware that it was not accurate.[6] Subsequently, in response to an inquiry from Goodman as to the size of the Fund, Dohmen responded that the Fund would not be "very big" until he had established a track record and that it would consist mostly of "accredited investors" referred to him by friends.[7] On December 9, 2011, within two weeks of receiving that reply, Goodman wired $500,000 to Dohmen (Second Investment). A few days after transmitting the wire, Goodman again inquired about other investors in the Fund. Dohmen advised him that "'[p]ersonal friends [of his] that have expressed interest [in the Fund] are now reviewing the [Fund] documents.'"[8] That statement was "knowingly false."[9] The next day, the Second Investment was invested in the Fund.

On May 14, 2012, Dohmen informed Goodman that there were only two investors in the Fund—himself and Goodman—a revelation that apparently "shocked" Goodman.[10] Despite being offered an opportunity to withdraw his investment, Goodman declined. In hindsight, Goodman's decision turned out to be unwise. On June 30, 2012, the Fund's net asset value was roughly $800,000. By the beginning of November of 2012, the Fund's net asset value dropped to approximately $500,000, and by the end of the year, it was down to approximately $357,000. In July of 2014, the Fund's net asset value was approximately $100,000.[11]

In January of 2015, Goodman brought suit against Dohmen in a federal district court in California alleging common law fraud, securities fraud and breach of fiduciary duty.[12] Although the district court found that, in connection with the Second Investment, Dohmen knowingly made false representations that Goodman had relied on, it ruled against Goodman on the common law fraud and securities laws claims, as Goodman had failed to show loss causation, given that the evidence did not suggest that the decline in the Fund's value was the result of anything other than market forces and trading decisions—and that Goodman's investment would have declined by the same amount even if there were additional investors.[13]

On the breach of fiduciary duty claim, however, the district court, citing to the Delaware Supreme Court's decision in *Malone v. Brincat*,[14] found that because Dohmen's misrepresentations were made in the context of a fiduciary seeking limited partner action, Goodman was relieved of the obligation to prove reliance or causation to succeed on his claim.[15] The district court reasoned, under *Malone*, that

> "[a]n action for breach of fiduciary duty arising out of disclosure violations in connection with a request for stockholder action does not include the elements of reliance, causation and actual quantifiable monetary damages."[16]

Since the parties did not dispute the materiality of Dohmen's misrepresentations, and Goodman had demonstrated that the presence of other investors in the Fund was important to him, the district court awarded Goodman compensatory damages for breach of fiduciary duty.

Dohmen appealed to the US Court of Appeals for the Ninth Circuit, which rejected his arguments other than the question of whether Goodman should have been required to prove loss causation on the basis that Dohmen did not make the material misrepresentation in the context of a request for limited partner action.[17] In connection with the resolution of the dispute, the Delaware Supreme Court addressed the following certified question:

> Under the stipulated facts of this dispute, does the general partner's request to the limited partner for a one-time capital contribution constitute a request for limited partner action such that the general partner has a duty of disclosure, and if the general partner fails to disclose material information in connection with the request, may the limited partner prevail on a breach of fiduciary duty

claim and recover compensatory damages without proving reliance and causation?[18]

The Supreme Court's Analysis

The Supreme Court concluded that, under the stipulated facts, Dohmen's request for a one-time capital contribution did not constitute a request for limited partner action such that Dohmen had a fiduciary duty of disclosure. It also concluded that, even if Dohmen had a fiduciary duty of disclosure and failed to disclose material information in connection with the request, Goodman would not be entitled to recover compensatory damages without proving reliance and causation.[19]

A stockholder-plaintiff need only demonstrate that a material misrepresentation was made or that a material fact was omitted.

In arriving at these conclusions, the Court started from the basic premise that, absent contractual modification, a general partner's duties to its limited partners parallel the duties that directors of a Delaware corporation owe to the corporation's stockholders—namely, the duties of care and loyalty.[20] While those fiduciary duties apply whenever directors communicate with stockholders, the specific obligations are defined by the context in which the communication occurs—as are the remedies for breach.[21] The Court divided such communications into two categories: (1) communications occurring in the context of a request for stockholder action (*e.g.*, a request for a vote on the adoption of a merger agreement or approval of an amendment to the certificate of incorporation, or a request for an investment decision or making an appraisal election); and (2) communications that are not associated with a request for stockholder action (*e.g.*, periodic financial disclosures).

In the first category, where directors are seeking discretionary action from stockholders generally, they have a duty to fully and fairly disclose all material facts within their control that bear on the stockholders' decision. The Court described the directors' duties in this context as implicating "the fiduciary duty of disclosure."[22] A breach of the fiduciary duty of disclosure occurs in cases where the directors have made a material misrepresentation or omitted a material fact. In the case of any such breach, stockholders are entitled to seek equitable relief (such as an order enjoining a meeting until supplemental or corrective disclosures are made) or damages. The Court noted that it has characterized a fiduciary's damages liability in that context as "per se," meaning that a stockholder-plaintiff need only demonstrate that a material misrepresentation was made or that a material fact was omitted—and need not demonstrate reliance, causation or damages.[23] The Court clarified, however, that the per se damages rule covers only breaches of the fiduciary duty of disclosure involving requests for stockholder action that impair the economic or voting rights of stockholders, and it only covers nominal damages. A stockholder seeking to recover compensatory damages for breach of the fiduciary duty of disclosure, by contrast, must prove reliance and causation.[24]

In the context of communications from directors outside of a request for action from stockholders, the Court held, the fiduciary duty of disclosure (as characterized above) does not apply. But the board's fiduciary duties of care and loyalty still apply such that the directors, when they elect to communicate with stockholders, must "deal honestly with stockholders."[25] To state a claim for breach of fiduciary duty for an alleged disclosure violation outside of a request for stockholder action, the stockholder-plaintiff must demonstrate that the directors knowingly disclosed false information. The scienter requirement serves to distinguish innocent or negligent disclosure violations from those involving an actual intent to mislead stockholders. The per se rule noted above does not apply in this context.[26]

As to the first part of the certified question before it, the Court found that Dohmen's one-time request for capital contribution did not implicate the fiduciary duty of disclosure, as it was not a request for limited partner action generally. To this end, the Court pointed to the Court of Chancery's decision in *Latesco, L.P. v. Wayport, Inc.*,[27] which involved claims that corporate insiders sought to invoke contractual rights of first refusal in the sale of a minority holder's shares while not disclosing material facts in respect of a pending transaction. The *Wayport* Court explained that the fiduciary duty of disclosure is not implicated in circumstances where the corporation is requesting action from an individual stockholder (as opposed to stockholders generally or a broad group of stockholders), reasoning that the requirement to disclose

> all material information regarding [a] decision presented to the stockholders is premised on the collective action problem that stockholders, in the aggregate are faced with when asked to vote or tender their shares,

which is a circumstance in which it would be impractical for each stockholder to have its particular questions and concerns addressed.[28]

In the present case, the Supreme Court found that Dohmen was not requesting limited partner action generally but was rather dealing with a single limited partner who had "direct access" to Dohmen.[29] Although Dohmen had no fiduciary duty of disclosure in this context, because he elected to speak about the number of investors, he had an obligation to speak honestly. That Dohmen knowingly made misrepresentations regarding the number of investors when he elected to address Goodman's inquiries (despite having no obligation to do so) resulted in the breach of his fiduciary duty of loyalty.

As to the second component of the certified question, the Supreme Court concluded that, even if Dohmen had a fiduciary duty of disclosure, Goodman would have nevertheless been required to show reliance and causation to obtain compensatory damages for his disclosure claim. In support of this conclusion, the Court pointed to its decision in *Malone v. Brincat*, which involved stockholder claims that the directors intentionally overstated the company's financial condition, leading to an eventual severe decline in its market value.[30] The Court of Chancery dismissed the complaint on the grounds that the directors had no fiduciary duty of disclosure as they were not requesting stockholder action, reasoning that federal securities laws already provided a remedy for inaccurate disclosures.[31] The Supreme Court in *Malone* reversed the lower court's dismissal with prejudice, allowing the plaintiffs to replead their complaint, holding that directors could be liable for breach of fiduciary duty by knowingly disseminating false information.[32] But, as the Supreme Court has made clear in a series of cases, the per se damages rule only applies in a context in which stockholder action is being sought—and it only presumes nominal damages.[33] Regardless of whether the alleged disclosure violation occurred within or outside of a request for stockholder action, a stockholder-plaintiff seeking compensatory damages would nevertheless be required to prove reliance, causation and damages.

Conclusion

The Delaware Supreme Court's opinion in *Dohmen* provides significant guidance regarding the circumstances in which directors may be liable for damages for breach of the fiduciary duty of disclosure in the context of a request for stockholder action, as well as the circumstances in which they may be liable for breaching their fiduciary duties by knowingly making false statements outside of a request for stockholder action, and the elements that a plaintiff will be required to prove to obtain an award of nominal damages or compensatory damages.

Notes

1. Dohmen v. Goodman, 2020 WL 3428213 (Del. June 23, 2020).
2. *Id.* at *1.

3. *Id.*
4. *Id.* at *1 – 2.
5. *Id.* at *2.
6. *Id.*
7. *Id.*
8. *Id.*
9. *Id.*
10. *Id.*
11. *Id.*
12. Goodman v. Dohmen, 2017 WL 3319110, at *18 (C.D. Cal. Aug. 3, 2017).
13. *Id.* at *15.
14. Malone v. Brincat, 722 A.2d 5 (Del. 1988).
15. *Dohmen*, 2017 WL 3319110, at *19.
16. *Id.* (*quoting Malone*, 722 A.2d at 12).
17. Goodman v. Dohmen, 777 Fed.Appx. 895 (9th Cor. 2019).
18. *Dohmen*, 2020 WL 3428213, at *1. The Ninth Circuit posed the question as follows: "In a Delaware limited partnership, does a general partner's request to a limited partner for a one-time capital contribution constitute a request for 'limited-partner action' such that the general partner has a duty of disclosure, and, if the general partner fails to disclose material information in connection with the request, may the limited partner prevail on a breach-of-fiduciary-duty claim without proving reliance and causation?" The Delaware Supreme Court reframed the question as set forth above, expressing the view that the reformulation would be most helpful to resolving the dispute. *Id.* at *1.
19. *Id.* at *10.
20. Relying on the finding that the Fund's limited partnership agreement did not waive fiduciary duties, the Court in its analysis drew on the case law that had developed in the corporate context. *Id.* at *3, n. 17. References in the Court's analysis (and in the discussion in this article) to "directors" or the "board" should in this context be construed as references to the "general partner," while references to "stockholders" should in this context be construed as references to "limited partners."
21. *Id.* at *4.
22. *Id.*
23. *Id.*
24. *Id.*
25. *Id.*
26. *Id.*
27. Latesco, L.P. v. Wayport, Inc., 2009 WL 2246793 (Del. Ch. July 24, 2009).
28. *Id.* at *6.
29. *Dohmen*, 2020 WL 3428213, at *6.
30. *Malone*, 722 A.2d 5.
31. Malone v. Brincat, 1997 WL 697940, at *2 (Oct. 30, 1997).
32. *Malone*, 722 A.2d 5 ("Here the complaint alleges (if true) an egregious violation of fiduciary duty by the directors in knowingly disseminating materially false information. . . . [T]he plaintiffs should have the opportunity to replead to assert any individual cause of action and articulate a remedy that is appropriate on behalf of the named plaintiffs individually, or a properly recognizable class consistent with Court of Chancery Rule 23.").
33. The Supreme Court in *Dohmen* reviewed the precedent underlying this conclusion, starting with In re Tri-Star Pictures, Inc. Litig., 634 A.2d 319, at 327, n.10 and 333 (Del. 1993), where it held that "existing law and policy have evolved into a virtual per se rule of damages for breach of the fiduciary duty of disclosure," and continuing with Loudon v. Archer-Daniels-Midland Co., where it clarified that "*Tri-Star* stands only for the narrow proposition that, where directors have breached their disclosure duties in a corporate transaction that has in turn caused impairment to the economic or voting rights of stockholders, there must at least be an award of nominal damages," and concluding with In re J.P. Morgan Chase & Co. Shareholder Litig., 906 A.2d 766, 773-774 (Del. 2006), which, it stated, eliminated any doubt that the per se damages rule is limited to nominal damages and only applies where the breach of the duty of disclosure causes impairment to the economic or voting rights of stockholders.