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Parametric Sound Corp. v. Dist. Ct., 133 Nev. Adv. Op. 59 (Sep. 14, 2017)

Lucy Crow
University of Nevada, Las Vegas -- William S. Boyd School of Law

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BUSINESS LAW: SHAREHOLDER CLAIMS

Summary

The Court clarified its holding in *Cohen v. Mirage Resorts, Inc.* by adopting the Delaware direct harm test to determine whether a shareholder's claim is direct or derivative. Under the direct harm test, the Court asks (1) who suffered alleged harm, and (2) who would receive benefit from recovery or another remedy? If the shareholder cannot establish a claim without showing injury to the corporation, the shareholder's claim fails.

Background

Petitioner Parametric agreed to a reverse triangular merger with Petitioner Turtle Beach. Parametric created a subsidiary, Paris Acquisition Corporation, which merged with Turtle Beach. Turtle Beach and Paris's merger made Turtle Beach a subsidiary of Parametric. Parametric's shareholders voted to issue new stock to Turtle Beach shareholders as consideration for the merger. Turtle Beach's shareholders received 80 percent interest in Parametric whereas Parametric's shareholders retained 20 percent interest.

Non-controlling shareholders brought several suits in district court, which were ultimately consolidated into a class action. The class action complaint alleged (1) breach of fiduciary duties by Parametric's board and (2) aiding and abetting of the breach of fiduciary duties by Parametric and Turtle Beach. Petitioners moved to dismiss the complaint, and the district court denied the motion.

Discussion

Writ relief is appropriate

The Court decided writ relief is appropriate because the case raises an important issue of law: the difference between direct and derivative shareholder claims.

Nevada caselaw regarding direct and derivative shareholder claims

Under *Cohen v. Mirage Resorts, Inc.*[2], "a derivative claim is one brought by a shareholder on behalf of the corporation to recover for harm done to the corporation;" whereas a direct claim is one brought by shareholders for direct injuries suffered that are separate injuries from any injury the corporation suffered. In *Cohen,* the court held that a merger resulting from wrongful conduct is a direct claim because a shareholder lost personal property: his interest in a specific corporation.[3] Because *Cohen* focused more on shareholder's rights after a merger than on the distinction between a direct and derivative claim, the Court determined it needed to adopt an explicit test to

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[1] By Lucy Crow.
[2] Cohen v. Mirage Resorts, Inc., 119 Nev. 1, 19, 62 P.3d 720, 732 (2003).
[3] *Id.*

distinguish between direct and derivative claims. The Court turned to Delaware's corporate law because it has often relied on Delaware's corporate law to establish Nevada law.

How Delaware distinguishes between direct and derivative claims

In *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*,[4] the Delaware Supreme Court established that to determine whether a claim is direct or derivative, the court must ask "(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)?"[5] Commentators dubbed this the "direct harm" test. The test's first prong requires the plaintiff to demonstrate that she can prevail without showing the corporation was injured. If so, then the second prong requires the plaintiff to show that recovery will benefit the individual and not the corporation.

We clarify Cohen consistent with Tooley's direct harm test

The Court adopted the Delaware Supreme Court's direct harm test in *Tooley* because it is straightforward and lower courts can easily apply the test.

The shareholder's complaint

In the present case, the shareholders merely challenged the merger, arguing all they needed to do under *Cohen* was allege that Petitioner's merger was improper. The Court disagreed with the shareholders because (1) focus should be on the direct harm and not the word "merger," (2) the "shareholders do not have a merger to challenge," and (3) the shareholders failed to show "direct harm without showing injury to the corporation."

The shareholder's complaint does not allege a merger encompassing subsequent cashed-out shareholders within the contemplation of Cohen

Because Parametric's subsidiary was merged with Turtle Beach, Parametric itself never merged with another corporation. As a result, the shareholders do not own any shares of a corporation that merged and cannot articulate a direct claim under the adopted test.

Equity dilution claims

The shareholders also argue that their Parametric stock was improperly diluted. The Court relied on Delaware law to establish that dilution claims are not direct claims because the diminishing value of stock also harms the corporation.[6] Since the corporation is harmed as well, the injury is a derivative claim. However, shareholders may bring equity expropriate claims, which "involve a controlling shareholder's or director's expropriation of value from the company, causing other shareholders' equity to be diluted."[7] Here, the shareholders failed to assert such a claim.

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[4] 845 A.2d 1031, 1035 (Del. 2004).
[5] *Id.* at 1033.
[6] Gentile v. Rossette, 906 A.2d 91, 99 (Del. 2006).
[7] Gatz v. Ponsoldt, 925 A.2d 1265, 1277 (Del. 2007).

Conclusion

Applying the direct harm test, the Court dismissed the shareholders' complaint because Parametric was never a party in a merger, thus, its shareholders did not suffer direct harm. However, the Court dismissed the complaint without prejudice so that the shareholders may amend the complaint to include any equity expropriation claims.