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When Do Derivative Claims "Survive" Mergers—'Massey II' Adds Clarity

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M&A practitioners are regularly faced with the question of whether derivative claims will survive a merger after which the plaintiff will no longer be a stockholder. Related questions include whether such claims are direct or derivative and what happens to the claims after the merger if the plaintiff is no longer able to assert them. In a recent decision, *In re Massey Energy Derivative & Class Litigation (Massey II)*, C.A. No. 5430-CB (Del. Ch. May 4), Chancellor Andre G. Bouchard provided helpful guidance on these issues. The court ruled that the "inseparable fraud" claim was derivative under the test articulated in *Tooley v. Donaldson, Lufkin & Jenrette*, 845 A.2d 1031 (Del. 2004). The Chancellor also ruled that ownership of a well-pleaded Caremark claim passes from the pre-merger plaintiff, suing derivatively on behalf of the company, to the acquirer unless one of two exceptions applies. Under the mere reorganization exception, the merger does not change the ultimate ownership of the company, so the plaintiff continues as a stockholder and may maintain its derivative claim. Under the fraud exception, the merger itself is the subject of a fraud claim because director defendants effectuated it merely to deprive plaintiffs of standing.

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Background

Massey II arose from an April 2010 explosion at Massey Energy Co.'s Upper Big Branch coal mine in West Virginia, which killed 29 miners. When Massey's stock price fell, potential acquirers approached Massey about a merger. Although Massey's board believed its stand-alone plan was a viable option, it engaged in a thorough sales process and agreed to merge with Alpha Natural Resources, Inc. Plaintiffs sought to preliminarily enjoin the merger, arguing, among other things, that the board failed to value their derivative claims and transfer them into a litigation trust for Massey stockholders' exclusive benefit. Then-Vice Chancellor Leo Strine denied the application, finding that stockholders had sufficient information to decide whether the company should remain independent and enjoining the merger unless Alpha transferred the derivative claims to a litigation trust would let Alpha walk away from the deal. See *In re Massey Energy Co. Derivative & Class Litigation ("Massey I")*, C.A. No. 5430-VCS (Del. Ch. May 31, 2011).

In *Massey II*, the plaintiffs alleged that former directors and officers of Massey breached their fiduciary duties by "causing Massey to employ a deliberate and systematic business plan of willfully disregarding both internal and external safety regulations." Plaintiffs made a direct claim based on an "inseparable fraud" theory—clarified in *Arkansas Teacher Retirement System v. Countrywide Financial*, 75 A.3d 888 (Del. 2013)—that defendants' mismanagement necessitated

the merger and sale of their stock at an inadequate price. Plaintiffs also made a derivative *Caremark* claim, alleging that the directors breached their duty of care. The Court of Chancery dismissed both counts for the reasons set out below.

Plaintiffs Failed To State A Direct Claim For 'Inseparable Fraud'

In addressing whether the "inseparable fraud" claim survived the merger, the court held that the plaintiffs needed to establish a direct claim under *Tooley*; constituting fraud or serious misconduct; that led to the merger. The *Massey II* plaintiffs failed to meet the first element. Under the *Tooley* test, a stockholder's claim is direct only if the suing stockholders—not the company—suffered the alleged harm and "would receive the benefit of any recovery or other remedy" directly. In many cases, the *Tooley* test results in a claim falling into a gray area between direct and derivative or, depending on one's view, straddling the two categories. Here, however, the court found this test straightforward because, for instance, there were no allegations that any defendant "engaged in misconduct to secure personal benefits for themselves to the detriment of any Massey stockholder." Instead, Chancellor Bouchard held the plaintiffs' mismanagement allegations implicated only the normal duty owed to the company to manage its affairs, and only the company would have benefitted from any recovery. The indirect harm suffered by stockholders when the company's stock dropped was not sufficient.

Plaintiffs Lost Standing To Pursue Well-Pleaded 'Caremark' Claim

The court dismissed the *Caremark* claim on a straightforward application of the continuous ownership rule. Because "a derivative claim is a property right owned by the nominal corporate defendant" that "flows to the acquiring corporation by operation of a merger," the continuous ownership rule requires stockholders pursuing derivative claims to hold shares throughout litigation to maintain standing. But under *Lewis v. Anderson*, 477 A.2d 1040 (Del. 1983), as clarified by *Lewis v. Ward*, 852 A.2d 896, 902 (Del. 2004), there are two well-settled exceptions: "if the merger is in reality merely a reorganization which does not affect plaintiff's ownership in the business enterprise," and "if the merger itself is the subject of a claim of fraud, being perpetrated merely to deprive shareholders of the standing to bring a derivative action." In *Massey II*, plaintiffs could not successfully invoke either exception. First, the merger was not a mere reorganization but an arm's length third-party merger. Second, the plaintiffs could not sufficiently plead that the Massey board's alleged pre-merger misconduct necessitated the merger.

Conclusion

There are at least three points of note from the court's decision. First, the court found plaintiffs' *Caremark* claim, which is "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment," well-pleaded. Second, the *Caremark* claim was dismissed under the continuous ownership rule, but the claim was not extinguished. Though plaintiffs lost standing to pursue the *Caremark* claim, the claim itself survived the merger and became as asset of the acquirer because it was derivative. The court specifically dismissed the claim "without prejudice to the ability of Alpha [the acquirer] ... to pursue the claim itself." Third, the court identified a few open issues worth following in future decisions on this issue. Notably, despite the Supreme Court's emphasis on the fraudulent nature of the defendants' conduct at issue in countrywide, Chancellor Bouchard raised the question of whether allegations of "serious misconduct" short of fraud would suffice. The chancellor also chose to apply a "conceivability" pleading standard to plaintiffs' inseparable fraud claim, but it is unclear whether the higher "particularity" standard traditionally associated with pleading fraud will be applied by other courts.

In short, Chancellor Bouchard's opinion in *Massey II* not only provides a useful roadmap for understanding not only whether a claim is direct or derivative under *Tooley*, but also the circumstances under which a claim of either type might continue post-merger under the control of pre-merger plaintiffs.

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