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DIRECTORS' AND OFFICERS' LIABILITY

DELAWARE REAFFIRMS STANDING REQUIREMENTS FOR DERIVATIVE CLAIMS

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In response to a recent request that it overrule decades-old law, the Delaware Supreme Court decisively reaffirmed the principle that a stock-for-stock merger eliminates the standing of a stockholder to maintain a derivative action. In *Lewis v. Ward,*[1] the court provided an excellent summary of the conceptual underpinnings of the doctrine and its exceptions, and reminded practitioners of the utility of the daunting sounding (but useful) "post-merger double derivative action."

Continuous Ownership Requirement

The facts of *Lewis* underscore the rigidity of derivative standing principles. Plaintiff, as a stockholder of Amax Gold, filed her original complaint in 1996 alleging a mismanagement claim derivatively on behalf of Amax. In 1998, Amax Gold announced that it intended to merge with Kinross Gold Corporation, an Ontario corporation with no prior relationship to Amax Gold. In a reverse triangular merger between Amax Gold and Kinross, Amax Gold merged with and into a wholly-owned subsidiary of Kinross. Pursuant to the Kinross merger, shares of common stock in Amax Gold, including the shares owned by the derivative plaintiff, were converted into the right to receive shares of Kinross. In a derivative action, however, the plaintiff sues to enforce a purported right or remedy belonging to a corporation in which plaintiff is a shareholder. Accordingly, defendants moved to dismiss the derivative complaint on the ground that the plaintiff was no longer a stockholder of Amax Gold, and therefore lacked standing to assert derivative claims on its behalf. The Court of Chancery granted the motion, and dismissed the original complaint and later an amended complaint that sought to bring the case within exceptions to the general rule.

On appeal, the Delaware Supreme Court took the opportunity to reassess the continuous ownership requirement and its exceptions. Ordinarily, a plaintiff who ceases to be a stockholder, whether by reason of a merger or for any other reason, loses standing to continue a derivative suit. Thus, a plaintiff who sells his or her shares after bringing suit also would lose standing to prosecute a derivative action. The reasons for insisting on continuous stockholder status are "to eliminate abuses associated with a derivative suit," and to prevent windfalls to plaintiffs who have accepted the benefits of a corporate transaction extinguishing their ownership of stock.[1] The underlying claim does not vanish -- by operation of 8 Del. C. § 259(a), upon the merger any derivative claims of the merged corporation pass to the surviving corporation, which then has the sole right and standing to prosecute the action.

Picking up on a theme advanced by Chancellor Chandler in another case,[2] the plaintiff in *Lewis* urged the Supreme Court to overrule these principles on the grounds that they clash with basic economic principles and fundamental principles of fairness and equity. She also argued that the continuous ownership requirement is inconsistent with *Blasband v. Rales*,[3] in which the Third Circuit purported to apply Delaware law and held that standing continues where the allegedly aggrieved corporation survives the merger as a wholly-owned subsidiary of the parent corporation. The Third Circuit reasoned that the combination of a direct pre-merger equity interest (in the subsidiary) and a direct but diluted post-merger equity interest (in the surviving corporation) is sufficient to meet the continuous ownership requirement necessary to prosecute pre-merger derivative claims. *Lewis* continued the Delaware courts' emphatic rejection of *Blasband* as inconsistent with "the established principle of Delaware corporate law recognizing the separate corporate existence and identity of corporate entities, as well as the statutory mandate that the management of every corporation is vested in its board of directors, not in its stockholders."

Delaware courts recognize two exceptions to the general rule that a merger extinguishes standing: (1) where the merger was effected solely to deprive shareholders of the standing to bring a derivative action and (2) where the merger is merely a reorganization that does not affect the plaintiff's ownership interest in the company. For the first exception to apply, the merger itself must be *directly* attacked as fraudulent and done only to eliminate derivative claims. Such fraud allegations must be made with the particularity required by Rule 9(b). Plaintiff in *Lewis* sought to bring her claims within the fraud exception by alleging "'that the merger was structured, with Kinross as parent and Amax Gold as subsidiary, to deny plaintiff standing to pursue th[e] action.'" The amended complaint did not allege, however, that the Amax Gold board of directors dictated the structure of the merger with Kinross, or that the Amax Gold board even considered the plaintiff's derivative claims when it approved the merger. Moreover, the court reasoned, it would have made economic sense for the then-majority owner of Amax Gold to approve the merger solely to eliminate the plaintiff's derivative claims only if the potential liability of the majority owner and its affiliated directors in the derivative action were greater than the financial loss they would sustain by accepting an inadequate price for Amax Gold shares. In these circumstances, the Supreme Court agreed with the Court of Chancery that the magnitude of the merger transaction, the blessing of an Amax Gold special committee, a merger with an unaffiliated entity and the absence of particularized facts suggesting that the potential derivative claim liability of the majority owner and its affiliated directors was so great as to have motivated them to steer Amax Gold into a pretextual merger with another publicly traded company at a sub-optimal price, all precluded application of the fraud exception.

Nor did the second exception -- mere reorganization -- fit the bill. The exception requires that the merger simply be a reshuffling of affiliated corporations. It does not apply, the court held, where the merger involves "two distinct corporations, each with its own board of directors, officers, assets and stockholders."

The Supreme Court emphasized that the plaintiff was not without a remedy to pursue her derivative claims. Although *Lewis* did not explicate the requirements of a double derivative suit, they are worth reviewing. She might have been able to bring a post-merger double derivative suit, but did not. The term "double derivative" denotes that a stockholder in a parent company may seek to enforce derivatively the parent corporation's derivative right to sue on behalf of its own subsidiary. In a double derivative suit, a stockholder of a parent corporation sues on behalf of the parent company for alleged wrongs to a subsidiary, *i.e.*, seeks to assert a cause of action belonging to a subsidiary of the parent.[4] A double derivative suit may properly allege any wrongs directly incurred by the parent company as well as those indirectly incurred by virtue of wrongs allegedly suffered by the subsidiary company. The parent's stockholder in effect brings the derivative claim on behalf of the subsidiary on the basis that the parent company has derivative rights to the cause of action held by the subsidiary. Consequently, both the parent and the subsidiary corporations are indispensable parties to a double derivative suit.[5] The stockholder must make two demands in a double derivative suit: demand must be made upon the boards of both the parent and subsidiary corporations.[6]

The double derivative procedure may be cumbersome, but the strict enforcement of standing requirements for derivative claims usually leaves it the only potential way to sustain a pre-merger derivative claim.

[1] 2004 WL 1535638 (Del. June 16, 2004).

[2] *Lewis v. Anderson*, 477 A.2d 1040, 1046 (Del. 1984).

[3] *See Ash v. McCall*, 2000 WL 1370341 (Del. Ch. Sep. 15, 2000).

[4] 971 F.2d 1034, 1046 (3d Cir. 1992).

[5] *Rales v. Blasband*, 634 A.2d 927 (Del. 1993).

[6] *Sternberg v. O'Neil*, 550 A.2d 1105, 1124 (1988).

[7] *Blasband v. Rales*, 971 F.2d 1034, 1047 (3d Cir. 1993).