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Arkansas Teacher: Standing & Derivative Claims under Delaware Law

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In the recently-decided case *Arkansas Teacher Retirement System v. Caiafa*,[1] the Delaware Supreme Court examined shareholder standing to bring derivative suits. Although plaintiffs have already started to seize upon *Arkansas Teacher* to argue that the Court significantly expanded the scope of such standing, closer examination reveals a different picture.[2] Far from effecting major changes in the ability of shareholders to proceed derivatively, the Delaware Court followed existing precedent and broke no new ground.[3]

The decision in *Arkansas Teacher* arose from the confluence of several different actions involving the difficulties faced by Countrywide Financial Corp. in the wake of the collapse of nationwide housing prices,[4] and the subsequent merger between Countrywide and Bank of America Corp. that was announced in January 2008. Following the merger's announcement, three Countrywide shareholders immediately filed separate suits in the Delaware Court of Chancery. The court consolidated the actions, and the Delaware plaintiffs then filed a Consolidated Verified Class Action Complaint seeking to enjoin the merger (the Delaware Merger Litigation). Among other things, the Delaware plaintiffs alleged that the individual defendants, who were directors of Countrywide, had violated their fiduciary duties to Countrywide shareholders by: (i) agreeing to a merger that provided inadequate compensation to Countrywide shareholders; (ii) discouraging other offers for Countrywide; (iii) intending to solicit shareholder approval via false and misleading proxy materials; (iv) agreeing to merger provisions that insulated Countrywide officers and directors

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from liability in connection with certain pending derivative actions; and (v) failing to value certain pending derivative claims in connection with the merger agreement.[5]

In exchange for supplemental disclosures prior to the vote on the proposed merger, the Delaware plaintiffs and the defendants negotiated a settlement agreement releasing nearly all merger-related claims. Countrywide shareholders approved the merger, which closed on July 1, 2008.[6] Numerous objectors opposed the settlement, including five former Countrywide shareholders that had commenced derivative actions against Countrywide officers and directors in the U.S. District Court for the Central District of California in the fall of 2007.[7] Following the merger's announcement, the California plaintiffs amended their complaint to include essentially the same merger-related claims previously filed by the Delaware plaintiffs. However, the California plaintiffs' merger-related claims were stayed in favor of the Delaware action.[8] After the merger closed, the California action was dismissed based on the well-settled rule that the California plaintiffs lost standing to pursue derivative claims against Countrywide following the merger between Countrywide and Bank of America.[9] The dismissal of the California action followed and cited to a prior dismissal of a derivative action brought in U.S. District Court for the District of Delaware.

In objecting to the proposed settlement of the Delaware Merger Litigation, the California plaintiffs argued that the Countrywide directors had breached their fiduciary duties in negotiating the merger by failing to value the derivative claims and "to carve these claims out of the merger, either by selling them or by preserving them in a litigation trust." The California plaintiffs sought to pursue those claims for alleged breach of fiduciary duty in connection with the merger, but the proposed settlement contained releases covering those claims.[10]

Vice Chancellor John W. Noble of the Delaware Court of Chancery overruled the California plaintiffs' objections, and the Delaware Supreme Court affirmed, holding that directors are not required to value or preserve assets such as a derivative suit piecemeal in connection with a merger, and that the California plaintiffs in any event had not shown a likelihood of prevailing on their derivative claims.[11] The Delaware Supreme Court also specifically noted that the merger had extinguished the California plaintiffs' standing to pursue their claims.[12] This unremarkable holding was followed by dicta discussing fraud alleged in connection with a merger.

The Court began by reciting the familiar rule that a plaintiff loses standing to pursue its derivative suit where the corporation in which the plaintiff holds stock merges with another company,[13] except (i) where the merger was "fraudulent and done merely to eliminate derivative claims," or (ii) where the merger is in fact a reorganization that does not affect the plaintiff's ownership of the enterprise.[14] The Court then noted that "[a] merger was one of few available alternatives" that would have both rescued Countrywide and provided the directors with legal protection from derivative suits "after the board's allegedly fraudulent schemes bankrupted a multibillion-dollar company. Delaware law recognizes a single, inseparable fraud where directors cover massive wrongdoing with an otherwise permissible merger."[15] The Court also stated that the California plaintiffs "pleaded facts supporting a colorable claim of fraud that, if proved, would have made the company's dissolution or auction a fait accompli."[16] Finally, the Court observed that if Vice Chancellor Noble had found that the California plaintiffs "had successfully pleaded [their] fraud claim, then [the California plaintiffs]—rather than Countrywide—could recover from the former Countrywide directors. In that case, the injured parties would be the shareholders who would have post-merger standing to recover damages instead of the corporation."[17]

Taking portions of the Court's discussion in isolation, plaintiffs have argued that *Arkansas Teacher* expanded the scope of the "fraud exception" to the rule that plaintiffs lose derivative standing following a merger. Under this reading, the fraud exception would include not only instances where the merger itself is allegedly "fraudulent and done merely to eliminate derivative claims,"[18] but also cases where alleged pre-merger fraud renders a

"company's dissolution or auction a fait accompli."

Such an "exception" would swallow the rule, however, as nearly every derivative plaintiff could assert that they retained standing based on the supposed severity of the alleged premerger fraud. The creation of such an exception is simply not supported by the Court's opinion. Rather, the dictum seized upon by plaintiffs is simply a reiteration of the longstanding rule that plaintiffs may pursue *direct* claims for fraud "even after the merger at issue has been consummated."[19]

Several factors support this conclusion. First, in discussing the connection between fraud and a subsequent merger, the Court cited to *Braasch v. Goldschmidt*. In *Braasch*, the Court of Chancery analyzed claims arising out of a tender offer and subsequent short form merger where the defendant majority shareholder allegedly induced shareholders to tender their shares by providing them with false, deceptive, and misleading information. Once sufficient shares were tendered to bring the defendant's holdings above 90%, the defendant utilized a statutory short form merger under 8 Del. Code § 253 to purchase the remaining shares at the same price as was offered to the stockholders in the tender offer.[20] The plaintiffs did not, however, allege that the short form merger *itself* was fraudulent.

On a motion to dismiss in the *Braasch case*, the Court divided the plaintiffs' claims into three different groups: derivative claims, direct individual claims and direct class claims. The Court granted the motion to dismiss with respect to the derivative claims, holding that "by virtue of the merger" the plaintiffs' "derivative rights… passed to the surviving corporation," thus depriving the plaintiffs of the right to proceed derivatively.[21] However, the Court denied the motion to dismiss with respect to the direct individual claims and a narrowly defined set of direct class claims. When discussing the direct individual claims the court noted the plaintiffs' allegation that "the merger was the final step of a conspiracy to accomplish an unlawful end by unlawful means." The court then stated that "if the means employed to accomplish that end were unlawful, the whole might be so tainted with illegality as to require invalidation of the merger."[22] In other words, since the short form merger depended on the defendant lawfully acquiring stock sufficient to meet the 90% threshold, fraud in connection with the tender offer could potentially affect the validity of the short form merger as it might be "so tainted with illegality [from the fraudulent tender offer] as to require invalidation."

Thus, when the Court in *Arkansas Teacher* stated that "[a]n otherwise pristine merger cannot absolve fiduciaries from accountability for fraudulent conduct that necessitated the merger" and cited *Braasch*, it was simply reiterating the long-standing principle that *direct* claims for fraud survive the merger. In contrast, and as the court in *Braasch* held, standing to bring derivative claims for fraud unrelated to the merger itself is necessarily extinguished following the merger.

Second, the Court's focus on direct rather than derivative liability is confirmed by the fact that the Court envisioned any recovery flowing to stockholders, not to the corporation. As the Delaware Supreme Court held in *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, derivative standing "must turn *solely* on the following questions: (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)?"[23] This standard has been repeatedly affirmed by the Court as the proper test for determining whether a claim is derivative or direct.[24]

In *Arkansas Teacher*, the Court stated that if the California plaintiffs "had successfully pleaded [their] fraud claim, then *[the California plaintiffs]—rather than Countrywide—could recover* from the former Countrywide directors. In that case, *the injured parties would be the shareholders* who would have post-merger standing to recover damages instead of the corporation."[25] Under the *Tooley* standard, the fraud claim hypothesized by the Court in *Arkansas Teacher* was necessarily direct because the plaintiff stockholder would be both the party "who suffered the alleged harm" and the party "who would receive the benefit of any recovery."[26] Thus, any argument that the Court was discussing derivative claims necessarily

implies that the Court overruled the standard articulated in *Tooley* without ever mentioning that case or the decisions affirming it—a highly improbable result, particularly when based on dicta.

A third, related reason why the Court's statements regarding post-merger standing were almost certainly intended to apply to direct claims, as opposed to expanding an exception allowing postmerger standing for derivative claims, is the basic principle that the assets and liabilities of the corporation being acquired, including derivative claims, pass by virtue of a merger to the acquiring corporation.[27] Thus, if recovery for a derivative claim flowed to the derivative plaintiffs "rather than Countrywide" following the merger, Bank of America would have been stripped of an asset that it had purchased from Countrywide, namely the right to recover from the directors for any wrongdoing. Indeed, any rule that allowed plaintiffs with premerger derivative standing to recover directly post-merger would effectively strip the acquiring company of an asset—the derivative claim. Again, it is unlikely that the Court would announce such a dramatic departure from existing law without even discussing the issue.

Not surprisingly, the narrow reading of *Arkansas Teacher* has been confirmed by a decision in the California action *In re Countrywide Financial Corp. Derivative Litigation*, where the California plaintiffs had asserted derivative claims based on allegedly fraudulent premerger conduct by the Countrywide Board of Directors.[28] Following the decision in *Arkansas Teacher*, the California plaintiffs sought reconsideration of the previously entered judgment on the pleadings for lack of postmerger standing with respect to their derivative claims against former Countrywide officers and directors. The Court denied the motion, holding that the decision in *Arkansas Teacher* "relied on established Delaware law and affirmed the decision of the Vice Chancellor… because the record did not support a finding that avoiding derivative liability was the principal reason for the Countrywide Board of Directors' approval of the merger with Bank of America."[29] The Court further noted that the California plaintiffs' argument relied on dicta regarding the ability of a shareholder, "not the corporation via a derivative suit," to recover damages through a direct fraud claim.[30]

Thus, while the Court's language in *Arkansas Teacher* may strike certain discordant notes, the only way to harmonize the decision is to read the Court's dicta as describing rights and remedies available to plaintiffs proceeding on direct rather than derivative claims. Regardless of the Court's intention, however, *Arkansas Teacher* will likely continue to be advanced by plaintiffs seeking to avoid extinguishment of their derivative claims following a merger.

NOTES

1. *Arkansas Teacher Retirement System v. Caiafa*, 996 A.2d 321 (Del. 2010). The authors represented two Countrywide directors in certain litigation involving Countrywide, although those two directors were not named as defendants in the action from which *Arkansas Teacher* was appealed.
2. Motion for Reconsideration of Judgment on the Pleadings at 13-20, *In re Countrywide Fin. Corp. Sec. Litig.*, Lead Case No. 07-CV-06923 MRP (MANx) (C.D. Cal. June 4, 2010).
3. A second recent case that appears more momentous on its face than a closer reading reveals is *MCG Capital Corp. v. Maginn*, 2010 WL 1782271 (Del. Ch. 2010), which held that preferred shareholders have standing to bring derivative suits. The court began "with the proposition that all stock is created equal," meaning "that all classes of stock enjoy the same rights and privileges unless an affirmative expression alters those rights." *MCG Capital*, 2010 WL 1782271 at *6. Among the default rights afforded to common stockholders is the right to bring a derivative action, provided that the plaintiff: (i) owns stock when the alleged wrong occurs; (ii) owns stock when the complaint is filed; and (iii) continues to own stock throughout the litigation. *Lewis v. Anderson*, 477 A.2d 1040, 1046 (Del. 1984). Stockholders must also show that they have made a demand upon the board of directors that they pursue the action and the board refused, or that the board "was disqualified from considering whether to pursue the action." *MCG Capital*, 2010 WL 1782271 at *6. Aside from these restrictions, however, the court noted that "the law does not appear to place a limit on the type or class of shareholder who may bring a derivative claim." Lacking any

direct authority in the case law, the court looked to statutory language for guidance. For example, 8 Del. C. § 327 requires derivative plaintiffs to plead that that they owned stock "at the time of the transaction of which [the] stockholder complains," but makes no distinction between different classes of stockholder. The court also noted that the Delaware Supreme Court "has made clear that '[a]ny rights, preferences and limitations of preferred stock must be expressly and clearly stated, as provided by statute.'" *MCG Capital*, 2010 WL 1782271 at *6. Moreover, *MCG Capital* is not the first derivative suit to be filed by a preferred shareholder. For example, in *Rosan v. Chicago Milwaukee Corp.*, 16 Del. J. Corp. L. 378, 1990 WL 13482, *7-8 (Del. Ch. 1990), the plaintiff was a preferred shareholder, yet the court did not question his standing on that basis even when addressing whether the plaintiff could proceed derivatively despite having failed to make a demand upon the board. Accordingly, the court in *MCG Capital* held that "preferred shareholders have standing to bring derivative claims unless the ability to bring a derivative claim has been expressly limited in the articles, preferred stock designations, or some other appropriate document." *MCG Capital*, 2010 WL 1782271 at *7.

4. Actions brought against Countrywide and its officers and directors included, among others: (i) *In re Countrywide Corp. S'holders Litig.*, C.A. No. 3464-VCN (Del. Ch.) (challenging the merger between Countrywide and Bank of America); (ii) *In re Countrywide Fin. Corp. Derivative Litig.*, Civ. No. 07-372-SLR (D. Del.) (alleging, among other things, that the Countrywide Financial Corp.'s board had caused the repurchase of shares owned by members of the board who were in possession of materially adverse, nonpublic company information); (iii) *In re Countrywide Derivative Litig.*, Lead Case No. 07-CV-06923-MRP(MANx) (C.D. Cal.) (alleging, among other things, that certain Countrywide board members breached their fiduciary duties by abandoning prudent lending practices, "engaging in illegal insider sales, and manipulating the company for personal gain."); and (iv) *In re Countrywide Fin. Corp. Sec. Litig.*, Lead Case No. CV 07-05295 MRP (MANx) (C.D. Cal.) (alleging, in part, violations of the 1933 Securities Act and the 1934 Securities Exchange Act in connection with allegedly illegal insider sales and alleged material misstatements regarding Countrywide's loan origination program).
5. *In re Countrywide Corp. Shareholders Litigation*, 2009 WL 2595739, *1 (Del. Ch. 2009), aff'd, 996 A.2d 321 (Del. 2010); *In re Countrywide Corp. Shareholders Litigation*, 2009 WL 846019, *2 (Del. Ch. 2009).
6. *In re Countrywide*, 2009 WL 2595739, at **1-2.
7. *In re Countrywide*, 2009 WL 846019, at *4.
8. *In re Countrywide*, 2009 WL 846019, at *4.
9. *In re Countrywide*, 2009 WL 846019, at *4.
10. *In re Countrywide*, 2009 WL 846019, at *4.
11. *Arkansas Teacher*, 996 A.2d at 322.
12. *Arkansas Teacher*, 996 A.2d at 322.
13. *Arkansas Teacher*, 996 A.2d at 323 (citing *Lewis v. Anderson*, 477 A.2d at 1049). In *Lewis*, the Court held that in order to bring a derivative suit, a shareholder plaintiff must (i) own stock when the alleged wrong occurs, (ii) own stock when the complaint is filed, and (iii) continue to own stock throughout the litigation. *Lewis v. Anderson*, 477 A.2d at 1046.
14. *Arkansas Teacher*, 996 A.2d at 322-323; *see also Lewis v. Ward*, 852 A.2d 896, 905 (Del. 2004); *Feldman v. Cutaia*, 951 A.2d 727, 731 n.20 (Del. 2008).
15. *Arkansas Teacher*, 996 A.2d at 323 (citing *Braasch v. Goldschmidt*, 41 Del. Ch. 519, 199 A.2d 760, 764 (1964)).
16. *Arkansas Teacher*, 996 A.2d at 323.
17. *Arkansas Teacher*, 996 A.2d at 323-24.
18. *Lewis v. Ward*, 852 A.2d at 905(citations omitted)
19. *Parnes v. Bally Entertainment Corp.*, 722 A.2d 1243, 1245 (Del. 1999).
20. *Braasch*, 199 A.2d at 762.
21. *Braasch*, 199 A.2d at 767.
22. *Braasch*, 199 A.2d at 764. Although there are also derivative claims at issue in *Braasch*, the court addressed those claims separately from its discussion of whether the merger was as a whole "tainted with illegality." *Braasch*, 199 A.2d at 767-768.
23. *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1033 (Del. 2004).
24. *See Feldman v. Cutaia*, 951 A.2d at 732; *Gentile v. Rossette*, 906 A.2d 91, 97 (Del. 2006).
25. *Arkansas Teacher*, 996 A.2d at 323-324 (emphasis added).
26. *Tooley*, 845 A.2d at 1033.
27. 8 Del. C. § 259(a) (providing that upon consummation of a merger, all assets of the target corporation vest in the surviving corporation); *Lewis v. Anderson*, 477 A.2d at 1050-1051.
28. Order Denying Motion for Reconsideration, *In re Countrywide Derivative Litig.*, Lead Case No. 07-CV-06923-MRP(MANx) (C.D. Cal. June 22, 2010).
29. Order Denying Motion for Reconsideration, *In re Countrywide*, Lead Case No. 07-CV-06923-MRP(MANx).
30. Order Denying Motion for Reconsideration, *In re Countrywide*, Lead Case No. 07-CV-06923-MRP(MANx).