



Reconfiguring Delaware's Law of Standing Following Mergers and Acquisitions

Posted by June Rhee, Co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Thursday September 5, 2013 at 9:24 am

Editor's Note: The following post comes to us from S. Michael Sirkin, an attorney at Seitz Ross Aronstam & Moritz LLP. This post is part of the Delaware law series, which is cosponsored by the Forum and Corporation Service Company; links to other posts in the series are available here.

My article, *Standing at the Singularity of the Effective Time: Reconfiguring Delaware's Law of Standing Following Mergers and Acquisitions*, examines the doctrine of standing as applied to mergers and acquisitions of Delaware corporations with pending derivative claims. The settled rules of direct and derivative standing break down at the "singularity of the effective time" of a merger, yielding to conflicting principles of standing, corporation law and policy, and basic equity. The path-dependent network of rules and exceptions that has developed is an outgrowth of case-by-case adjudication that now begs for a one-time, wholesale reconfiguration.

The article takes on that task, proposing three straightforward rules that need no exceptions:

- **First, stockholders of the target should have standing to challenge a merger directly on the ground that it failed to achieve adequate value for derivative claims.** Under existing law, target stockholders generally have standing to sue target directors to challenge a merger directly. But if target stockholders challenge the merger on the specific ground that it failed to achieve adequate value for derivative claims, then the plaintiffs must clear three additional hurdles to establish standing, under *Parnes v. Bally Entertainment Corporation*, 722 A.2d 1243 (Del. 1999) and its progeny. This so-called standing test is actually nothing more than a heightened pleading burden that gives directors a "merger defense," allowing them to merge away certain derivative claims in transactions that stockholder plaintiffs lack standing to challenge. The proposed rule would bring the law in this area back into step with general principles of standing, the fiduciary duty of loyalty, and the entire fairness standard of review by removing a disguised, merits-based evaluation of a plaintiff's claims at the pleading stage that is unlike any recognized, transactionally appropriate standard of judicial review.
- **Second, without exception, a merger should extinguish the derivative standing of former target stockholders.** Under existing law set forth in *Lewis v. Anderson*, 477 A.2d 1040 (Del. 1984), this general rule is subject to two narrow, equitable exceptions—a "fraud exception" and a "reorganization exception"—that have been misconceived and misunderstood. The exceptions were misconceived as exceptions that would permit continued derivative standing when instead they should be seen as circumstances in which another species of claim (i.e., a direct claim challenging the merger) could exist. And, the exceptions have been misunderstood because, in the nearly thirty years since being recognized by the Delaware Supreme Court, they have never been applied by a Delaware court to confer standing in an actual case. As a result, the Delaware courts have never fleshed out how the exceptions would work, including who would receive the benefit of any recovery in such a case. Nonetheless, settled Delaware law, including Section 259 of the DGCL, provides that derivative claims pass to the acquiror in a merger. Therefore, to recognize continued derivative standing within the so-called exceptions would permit a former target stockholder to litigate claims that benefit the acquiror, a result that would conflict with traditional standing doctrine and the adequacy requirements for representative plaintiffs. The proposed

rule would eliminate the concept of the *Anderson* exceptions from Delaware law and avoid these potential conflicts.

- ***Third, all stockholders of the acquiror as of the time of a merger announcement should be deemed contemporaneous owners with respect to claims acquired in the merger.*** Under existing law, Section 327 of the DGCL requires that a derivative plaintiff be a stockholder as of the time of the transaction giving rise to the derivative claims. This rule makes it nearly impossible for a stockholder of the acquiror to litigate derivatively claims acquired by cash-out merger. This is true even in cases where the stockholder could successfully plead demand futility. But there is no policy justification, underlying Section 327 or otherwise, for this blanket prohibition of stockholder derivative suits post-merger. The proposed rule would therefore restore a critical accountability mechanism to stockholders whose companies happen to acquire claims by merger, enabling stockholders to sue in the corporation's name when the board of directors cannot be expected to decide impartially whether or not to do so.

The three rules proposed in my article would depart only slightly from existing law. Each would be a marked improvement on its own. All three together would bring much needed clarity, coherence, and fulfillment of purpose to this important area of Delaware law.

Fortuitously, the Delaware Supreme Court now has an opportunity to reassess the legal rules applicable to this important area of Delaware law. The opportunity comes by way of California. In pending stockholder litigation arising out of the financial crisis-era downfall of Countrywide and its resulting acquisition by Bank of America, the United States Court of Appeals for the Ninth Circuit has certified to the Delaware Supreme Court this question of law:

Whether, under the “fraud exception” to Delaware’s continuous ownership rule, shareholder plaintiffs may maintain a derivative suit after a merger that divests them of their ownership interest in the corporation on whose behalf they sue by alleging that the merger at issue was necessitated by, and is inseparable from, the alleged fraud that is the subject of their derivative claims.

Briefing is complete, and the Delaware Supreme Court heard oral argument on July 3, 2013.

The full article may be downloaded here.

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