Standing at the Singularity of the Effective Time: Reconfiguring Delaware's Law of Standing Following Mergers and Acquisitions

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This article examines the doctrine of standing as applied to mergers and acquisitions of Delaware corporations with pending derivative claims. Finding the existing framework of overlapping rules and exceptions both structurally and doctrinally unsound, this article proposes a novel reconfiguration under which Delaware courts would follow three black-letter rules: (1) stockholders of the target should have standing to sue target directors to challenge a merger directly on the basis that the board failed to achieve adequate value for derivative claims; (2) a merger should eliminate target stockholders' derivative standing; and (3) stockholders of the acquiror as of the time a merger is announced should be deemed contemporaneous owners of claims acquired in the merger for purposes of derivative standing. Following these rules would restore order to the Delaware law of standing in the merger context and would advance the important public policies served by stockholder litigation in the Delaware courts.

INTRODUCTION

A well-developed body of Delaware law governs derivative actions.[1] A similarly robust and sophisticated body of Delaware law governs mergers and acquisitions.[2] But the law that applies where those two worlds collide is another matter entirely. Consider an example.

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1. *See, e.g.*, VGS, Inc. v. Castiel, C.A. No. 17995, 2003 WL 723285, at *11 (Del. Ch. Feb. 28, 2003) (noting the "the well-developed body of Delaware law governing derivative suits by stockholders of a corporation"); *see also* John C. Coffee, Jr., *New Myths and Old Realities: The American Law Institute Faces the Derivative Action*, 48 BUS. LAW. 1407, 1411 (1993) ("For the future, the *Principles* probably represent the leading alternative to the well developed Delaware case law, particularly with regard to derivative actions. In jurisdictions where the law remains undeveloped, courts will face a choice between the ALI's approach and Delaware's approach. Thus, this Article will use Delaware law as a point of reference.").

2. *See, e.g.*, Christina M. Sautter, *Rethinking Contractual Limits on Fiduciary Duties*, 38 FLA. ST. U. L. REV. 55, 58 n.11 (2010) ("The focus of this Article is on Delaware law due to Delaware's domination of the public company charter market and its well-developed body of case law in the mergers and acquisitions arena."); *see also* Daniel R. Fischel, *The Business Judgment Rule and the* Trans Union

The directors of a $10 billion Delaware corporation loot the company, stealing $100 million of the corporation's cash. The loss of $100 million in cash is reflected on the company's balance sheet, but so is the gain of a corresponding litigation asset: a claim against the directors to recover the misappropriated funds. At some point in the future, this intangible corporate asset could be liquidated through litigation against the wrongdoers, either by the corporation itself or derivatively by a stockholder plaintiff on the corporation's behalf. The stockholders therefore collectively now own a $9.9 billion operating business and a $100 million litigation asset.[3]

Sophisticated actors that they are, the directors now negotiate a triangular merger by which the $10 billion corporation is acquired for $9.9 billion. The directors secure indemnification for themselves, while the stockholders receive nothing in the merger for their indirect ownership of the $100 million litigation asset. In effect, the directors transfer the wrong they did to the corporation onto the stockholders by virtue of an unfair merger.

When these aggrieved stockholders attempt to challenge the merger in court, they find themselves locked out. The stockholders who suffered directly the uncompensated loss of a $100 million asset lack standing to challenge the self-interested misconduct of their elected fiduciaries.[4] Once the original claim is labeled as derivative, Delaware courts consistently have held that the pre-merger stockholders lack standing to sue without fully contemplating how the merger transforms the nature of the claim.[5] Likewise, and regardless of the price paid in the merger, stockholders of the acquiring corporation *also* lack standing to assert derivatively[6] the $100 million claim they now indirectly own, as control of the derivative cause of action passes to the acquiror.[7]

Case, 40 BUS. LAW. 1437, 1454 (1985) ("For many years, Delaware has enjoyed a dominant position in corporate law. The main features of Delaware's corporation law—a rich and stable body of precedents, a receptivity to value-increasing transactions such as mergers and acquisitions, and, most importantly, a recognition that allowing firms flexibility in structuring their affairs operates to the benefit of investors—have resulted in a percentage of firms incorporating in Delaware completely disproportionate to its size." (footnote omitted)).

3. *See In re* Primedia, Inc. S'holders Litig., 67 A.3d 455, 487 (Del. Ch. 2013) ("Before the Merger, Primedia owned both its operating business (worth $316 million) and the right to a potential recovery on the *Brophy* claim (worth $190 million).").

4. *Id.* at 477 ("A plaintiff claiming standing to challenge a merger directly . . . because of a board's alleged failure to obtain value for an underlying derivative claim must meet a three part test. . . . [T]he value of the derivative claim must be material in the context of the merger."); *see also In re* Massey Energy Co. Derivative & Class Action Litig., C.A. No. 5430-VCS, 2011 WL 2176479, at *28 (Del. Ch. May 31, 2011) ("[I]t appears that the total amount . . . is $95 million, which is not a trifle but also not material in the context of an $8.5 billion Merger.").

5. *See, e.g.*, Feldman v. Cutaia, 956 A.2d 644, 659–61 (Del. Ch. 2007); *In re* Syncor Int'l Corp. S'holders Litig., 857 A.2d 994, 997–98 (Del. Ch. 2004); *In re* First Interstate Bancorp Consol. S'holder Litig., 729 A.2d 851, 861–64 (Del. Ch. 1998).

6. *See* DEL. CODE ANN. tit. 8, § 327 (2011) ("In any derivative suit instituted by a stockholder of a corporation, it shall be averred in the complaint that the plaintiff was a stockholder of the corporation at the time of the transaction of which such stockholder complains or that such stockholder's stock thereafter devolved upon such stockholder by operation of law.").

7. *See, e.g.*, Kramer v. W. Pac. Indus., Inc., 546 A.2d 348, 355 (Del. 1988) ("Title to such claims has passed by operation of law to [the acquiror], and [the acquiror] alone has the right to determine whether to pursue such claims against the defendants.").

As a result, by compounding one breach of their duty of loyalty (looting the corporation) with a second one (entering into the self-interested merger in part to escape personal liability), these directors have made themselves bulletproof. They have committed the perfect breach, making off with $100 million in such a way that there is "likely no proper plaintiff on earth."[8]

This paradoxical outcome bespeaks a broken system. The settled rules of stockholder litigation break down at the "singularity of the effective time"[9] of a merger, yielding to conflicting principles of standing, corporation law and policy, and equity. What exists today would never have been designed. The path-dependent network of rules, exceptions, and exceptions to those exceptions is an outgrowth of case-by-case adjudication that now begs for a one-time, wholesale reconfiguration. This article takes on that task.

A systematic rebuild must address three intractable root causes of the deterioration of the current system: (1) the three-part standing test established by *Parnes v. Bally Entertainment Corp.*[10] and its progeny; (2) the two equitable exceptions set forth in *Lewis v. Anderson*[11] to the general rule that a merger extinguishes a target stockholder's derivative standing; and (3) the application of the contemporaneous ownership requirement[12] to bar post-merger derivative litigation on behalf of the acquiror of claims acquired by a cash-out merger.

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8. Golaine v. Edwards, C.A. No. 15404, 1999 WL 1271882, at *7 (Del. Ch. Dec. 21, 1999). A corporate technician would object to this statement and would point out that, as a matter of corporate law, the acquiror itself could file suit. But as a matter of contract, the acquiror could possibly have given up this right in the merger agreement. *Id.* at *4 ("At best, any derivative claim may be asserted by the target corporation itself. More likely, as is overwhelmingly probable in this case, the new acquiror gave up such a right in the merger agreement itself."). And even if the acquiror has not given up its right to sue, it probably has advancement and indemnification obligations to the defendants that would require it to fund both sides of the litigation in real time. *See* Carsanaro v. Bloodhound Techs., Inc., 65 A.3d 618, 664 (Del. Ch. 2013) (explaining that an acquiror often has advancement and indemnification obligations in this context, whether by statute, contract, or in the target corporation's charter or bylaws). This is an obstacle that could make post-closing litigation unpalatable to the acquiror even though the acquiror ultimately could be entitled to repayment from the defendants. *See* Del. Code Ann. tit. 8, §§ 145(b), 145(e) (2011). "[M]uch less commonly," the acquiror may be barred from litigating the claim by the *Bangor Punta* doctrine. *Golaine*, 1999 WL 1271882, at *4 n.16 (citing Bangor Punta Operations, Inc. v. Bangor & Aroostook R.R. Co., 417 U.S. 703 (1974)). For all of these reasons, "[w]hile the courts may indulge the notion that the claims still 'survive'" in the control of the acquiror, "they usually die as a matter of fact." *Id.* at *5; *accord* Penn Mart Realty Co. v. Perelman, C.A. No. 8349, 1987 WL 10018, at *2 (Del. Ch. Apr. 15, 1987) ("I agree that it is highly unlikely that Pantry Pride, which now controls Revlon, will seek to redress the allegedly excessive severance payments or allegedly excessive fees and therefore these abuses (if they are abuses) are not likely to be addressed.").

9. *See* Brinckerhoff v. Tex. E. Prods. Pipeline Co., 986 A.2d 370, 383 (Del. Ch. 2010); *see also In re* BankAtlantic Bancorp, Inc. Litig., 39 A.3d 824, 835 (Del. Ch. 2012).

10. 722 A.2d 1243 (Del. 1999).

11. 477 A.2d 1040 (Del. 1984). The plaintiff Harry Lewis enjoyed such a prolific career as an "apparent champion of the minority shareholders" that it caused Chancellor Brown to wonder if Mr. Lewis was, in fact, a mythical hero. *See* Lewis v. Anderson, 453 A.2d 474, 475 n.1 (Del. Ch. 1982) ("I must facetiously admit that more than once the suspicion crossed my mind that perhaps no such person as Harry Lewis actually existed, that perhaps he was merely a fiction—a 'street name' if you will—utilized at random by various counsel for the purpose of bringing class and derivative actions for the needed protection of shareholder interests.").

12. Del. Code Ann. tit. 8, § 327 (2011).

Stockholders who challenge a merger on the ground that it fails to compensate them for their share of the target corporation's litigation assets must first pass the *Parnes* test to establish standing to sue.[13] Yet despite being nominally about standing, the *Parnes* test is actually a makeshift, merits-based pleading standard[14] that permits fiduciaries to merge away certain derivative claims with impunity, leaving stockholders without recourse to enforce the supposedly "unremitting" fiduciary duties they are owed.[15]

The *Anderson*[16] exceptions have also injected confusion into Delaware law. The fraud exception in particular has come unmoored from its historical foundations through a contextually myopic interpretation of the term "fraud."[17] And, in the nearly three decades since *Anderson* was decided, the recognized exceptions that are narrow in theory have proven non-existent in fact.[18]

The contemporaneous ownership requirement[19] generally shrinks the pool of potential derivative plaintiffs,[20] ostensibly to guard against the purported evil of

13. *In re* Primedia, Inc. S'holders Litig., 67 A.3d 455, 477 (Del. Ch. 2013) ("A plaintiff claiming standing to challenge a merger directly under *Parnes* because of a board's alleged failure to obtain value for an underlying derivative claim must meet a three part test.").

14. Golaine v. Edwards, C.A. No. 15404, 1999 WL 1271882, at *7 (Del. Ch. Dec. 21, 1999) ("[T]he derivative-individual distinction as articulated in *Parnes* is revealed as primarily a way of judging whether a plaintiff has stated a claim on the merits. In this sense, the distinction seems to be a quite sensible basis for determining which, if any claims, ought to survive a merger."); *In re* Gaylord Container Corp. S'holders Litig., 747 A.2d 71, 82 (Del. Ch. 1999) ("In a merger extinguishing plaintiffs' status as stockholders, the question of whether the plaintiffs' claims are individual or derivative becomes outcome determinative. If the claims are individual, the plaintiffs' claims survive the merger. If not, the plaintiffs' claims are extinguished.").

15. Malone v. Brincat, 722 A.2d 5, 10 (Del. 1998) ("[T]he fiduciary duty of a Delaware director is unremitting.").

16. *Anderson*, 477 A.2d at 1046 n.10.

17. *See infra* notes 155–59 and accompanying text.

18. Even the de jure existence of the *Anderson* exceptions muddies the doctrinal waters. Control of a target's legal claims passes to the acquiror in a merger. Lambrecht v. O'Neal, 3 A.3d 277, 284 (Del. 2010) ("*Lewis v. Anderson* holds that where the corporation on whose behalf a derivative action is pending is later acquired in a merger that deprives the derivative plaintiff of his shares, the derivative claim—originally belonging to the acquired corporation—is transferred to and becomes an asset of the acquiring corporation as a matter of statutory law."). When the claim changes hands from target to acquiror, a target stockholder becomes a stranger to the claim, an "empty plaintiff" with no rightful economic interest in the recovery. Parfi Holding AB v. Mirror Image Internet, Inc., 954 A.2d 911, 940 (Del. Ch. 2008) ("Because of the important policy purpose served by the continuous ownership rule, the rule is a bedrock tenet of Delaware law and is adhered to closely. Where, as here, a derivative plaintiff has become an 'empty plaintiff,' the clear policy purpose served by the traditional application of the continuous ownership rule is implicated." (citations omitted)). As a result, a former target stockholder could not be an adequate derivative plaintiff under Court of Chancery Rule 23.1 and the Due Process Clause. *See* South v. Baker, 62 A.3d 1, 21–22 (Del. Ch. 2012) ("A plaintiff seeking to maintain derivative claims must show that she can meet her ongoing fiduciary obligations, including by satisfying the adequacy requirements implicit in Court of Chancery Rule 23.1. The requirement of adequate representation flows from the Due Process Clause of the United States Constitution and the protection it affords the non-parties on whose behalf the representative plaintiff purports to litigate." (citations omitted)).

19. *See* DEL. CODE ANN. tit. 8, § 327 (2011) ("In any derivative suit instituted by a stockholder of a corporation, it shall be averred in the complaint that the plaintiff was a stockholder of the corporation at the time of the transaction of which such stockholder complains or that such stockholder's stock thereafter devolved upon such stockholder by operation of law.").

20. J. Travis Laster, *Goodbye to the Contemporaneous Ownership Requirement*, 33 DEL. J. CORP. L. 673, 691 (2008) ("By arbitrarily fixing and then shrinking the pool of stockholders who

a purchased lawsuit.[21] As applied against stockholders of a corporation that has made an acquisition, the rule is disconnected from its underlying prescriptive purposes.[22] Nevertheless, it forecloses nearly all post-merger derivative litigation on an acquiror's behalf of claims acquired by merger,[23] thereby "transfer[ring] some degree of wealth from corporations to the individuals who commit corporate wrongs."[24] Moreover, permitting post-merger derivative suits by stockholders of the acquiror would help cure the ills caused by the *Parnes* test. No more could directors simply steer the target corporation into friendly hands that promise, explicitly or implicitly, not to sue the target directors. The stockholders would not stand for it.

A properly functioning system of legal rules would hold fiduciaries accountable for their misconduct and compensate stockholders fairly when they are harmed.[25] Delaware corporate law already guards well against over-deterrence by protecting directors who take well-intentioned business risks.[26]

can bring derivative claims, section 327 exacerbates the agency costs inherent in the corporate form.").

21. *See* Rosenthal v. Burry Biscuit Corp., 60 A.2d 106, 111 (Del. Ch. 1948).

22. This assumes that the would-be post-merger derivative plaintiff is a non-controlling stockholder and thus is not causing the corporation to consummate the merger in pursuit of the purchased lawsuit. But if the purported stockholder plaintiff did control the corporation, she could cause the corporation to litigate the claims itself, which would be permissible. *See* DEL. CODE ANN. tit. 8, § 327; *see also* Shaev v. Wyly, C.A. No. 15559-NC, 1998 WL 13858, at *4 (Del. Ch. Jan. 6, 1998) ("The contemporaneous ownership requirement of section 327 was not implicated in *Anadarko* because the former subsidiary corporation brought suit on its own behalf; no shareholder sued derivatively.").

23. *See* DEL. CODE ANN. tit. 8, § 327.

24. Laster, *supra* note 20, at 691 & n.89 ("If derivative actions promote firm value, even marginally, then a rule that forecloses some number of both meritorious and meritless derivative actions will, all things being equal, transfer some degree of wealth from corporations to the individuals who commit corporate wrongs.").

25. *See* Martin Petrin, *Assessing Delaware's Oversight Jurisprudence: A Policy and Theory Perspective*, 5 VA. L. & BUS. REV. 433, 457 (2011) ("Shareholder fiduciary duty litigation is commonly thought to serve two main goals, ex post compensation and, above all, ex ante deterrence."); Jessica Erickson, *Corporate Misconduct and the Perfect Storm of Shareholder Litigation*, 84 NOTRE DAME L. REV. 75, 104–05 (2008) (discussing private and public models of derivative suits); *see generally* James D. Cox, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures*, 52 GEO. WASH. L. REV. 745 (1984) (recognizing compensation and deterrence as the purposes of derivative actions); *see also* Kenneth B. Davis, *The Forgotten Derivative Suit*, 61 VAND. L. REV. 387 (2008) (empirical analysis concluding that the remedial and deterrent aspects of derivative litigation play an especially substantial role in cases involving controlling stockholders); John C. Coffee, Jr. & Donald E. Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 302–09 (1981) (recognizing compensation and deterrence purposes, and advocating deterrence as the dominant one).

26. This is the conceptual underpinning of the business judgment rule, which serves as "the first protection against the threat of sub-optimal risk-taking." *See* Gagliardi v. Trifoods Int'l, Inc., 683 A.2d 1049, 1052 (Del. Ch. 1996) ("Shareholders' investment interests, across the full range of their diversifiable equity investments, will be maximized if corporate directors and managers honestly assess risk and reward and accept for the corporation the highest risk adjusted returns available that are above the firm's cost of capital. But directors will tend to deviate from this rational acceptance of corporate risk if in authorizing the corporation to undertake a risky investment, the directors must assume some degree of personal risk relating to ex post facto claims of derivative liability for any resulting corporate loss."). Likewise, exculpatory charter provisions, permitted by section 102(b)(7) of the Delaware General Corporation Law (the "DGCL"), guard against the risks of over-deterrence, both of director service and of director conduct. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2011); *see also*

In the *Parnes* context, under-deterrence and under-compensation pose bigger concerns.

And, especially in the area of mergers and acquisitions, the Delaware courts strive to give clear and forthright guidance to managers of and investors in Delaware corporations. Consistency, predictability, and doctrinal coherence are paramount.[27] The current system falls short on all counts.

The many problems with the current system are all fixable. This article presents a system-wide examination and proposes a novel, wholesale reconfiguration of this area of the law.[28] This proposal consists of three bright-line rules that need no exceptions.

First, when a merger extinguishes derivative claims, all stockholders of the target corporation should have standing to challenge the merger directly in a breach of fiduciary duty suit against the target corporation's board of directors. This rule would eliminate an opportunity that now exists for fiduciaries to merge away certain derivative claims against them in transactions that stockholder plaintiffs lack standing to challenge. It would also 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.[29]

Second, a merger should extinguish standing in all cases for former target stockholders to assert derivative claims. This rule would exorcise the ghost, lurking in *Anderson* and its progeny, of the unnecessary and unworkable equitable exceptions. This rule would also advance the doctrinal clarity and predictability of the law governing mergers of Delaware corporations, and would relieve the tension between the *Anderson* exceptions and section 259 of the DGCL.[30]

Malpiede v. Townson, 780 A.2d 1075, 1095 (Del. 2001) ("The purpose of this statute was to permit stockholders to adopt a provision in the certificate of incorporation to free directors of personal liability in damages for due care violations, but not duty of loyalty violations, bad faith claims and certain other conduct. Such a charter provision, when adopted, would not affect injunctive proceedings based on gross negligence. Once the statute was adopted, stockholders usually approved charter amendments containing these provisions because it freed up directors to take business risks without worrying about negligence lawsuits.").

27. *See, e.g.*, 3Com Corp. v. Diamond II Holdings, Inc., C.A. No. 3933-VCN, 2010 WL 2280734, at *5 (Del. Ch. May 31, 2010) ("Delaware has a considerable interest in ensuring that corporate entities seeking a business combination under its laws may expect consistent and predictable treatment when appearing before its courts.").

28. Candidly, although this article advocates a novel, one-time reconfiguration of all of these interrelated rules, parts of this proposal are unoriginal. Chancellor Allen first extolled the virtues of the first two rules nearly thirty years ago. *See* Merritt v. Colonial Foods, Inc., 505 A.2d 757 (Del. Ch. 1986) (permitting stockholder class action challenging a merger on the basis that the merger unfairly extinguished derivative claims, and advocating for the reconsideration of the *Anderson* exceptions). And the third finds ample support in the Delaware Supreme Court's 2010 decision in *Lambrecht v. O'Neal*, 3 A.3d 277 (Del. 2010).

29. *See infra* Part III.A.

30. *See infra* Part III.B.

Third, all stockholders of the acquiror as of the time of a merger announcement should satisfy the contemporaneous ownership requirement with respect to claims acquired in the merger. This would restore a critical accountability mechanism to stockholders whose companies happen to acquire claims by merger by 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.[31]

These proposed rules 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 the law.

Part I of this article briefly surveys the law of standing as applied to stockholder actions. Part II identifies the current system's doctrinal infirmities from a holistic and historical perspective. Part III builds on this foundation and proposes a reconfigured set of rules that would eliminate all of these observed weaknesses. A brief conclusion follows.

I. Standing Doctrine in Stockholder Actions

A. "Standing Is the Key to the Courthouse Door; Those Who Possess the Key, Possess Power"[32]

"The term 'standing' refers to the right of a party to invoke the jurisdiction of a court to enforce a claim or to redress a grievance."[33] Accordingly, standing doctrine focuses on the identity of the plaintiff and the connection between plaintiff and claim.[34]

Standing is not a merits-based defense. Nevertheless, when standing is lacking for non-curable reasons, it effectively results in final dismissal.[35] Doctrinally, the standing inquiry is distinct from, and logically prior to, a court's consideration of the merits of the case.[36]

31. *See infra* Part III.C.

32. *In re* Merrill Lynch & Co. Sec., Derivative & ERISA Litig., 597 F. Supp. 2d 427, 431 (S.D.N.Y. 2009).

33. Dover Historical Soc'y v. City of Dover Planning Comm'n, 838 A.2d 1103, 1110 (Del. 2003); *see also* Warth v. Seldin, 422 U.S. 490, 498 (1975) ("In essence the question of standing is whether the litigant is entitled to have the court decide the merits of the dispute or of particular issues.").

34. Ala. By-Products Corp. v. Cede & Co., 657 A.2d 254, 264 (Del. 1995) ("[T]he question of standing focuses on whether an individual possesses an actual stake in the controversy for which he seeks judicial resolution."); Stuart Kingston, Inc. v. Robinson, 592 A.2d 1378, 1382 (Del. 1991) ("Unlike the federal courts, where standing may be subject to stated constitutional limits, state courts apply the concept of standing as a matter of self-restraint to avoid the rendering of advisory opinions at the behest of parties who are 'mere intermeddlers.'").

35. *See, e.g.*, *In re* Frazer, 721 A.2d 920 (Del. 1999) (denying motion to dismiss in recognition that minor child's age-based standing defect is curable by appointment of a guardian ad litem); *see also* H.R. Techs., Inc. v. Astechnologies, Inc., 275 F.3d 1378, 1385 (Fed. Cir. 2002) (recognizing dismissal with prejudice where it appears "plainly unlikely that the plaintiff would have been able to cure the standing problem").

36. *Warth*, 422 U.S. at 498 ("In essence the question of standing is whether the litigant is entitled to have the court decide the merits of the dispute or of particular issues."); *id.* at 500 ("[S]tanding in

As impersonal entities, corporations present salient questions about standing, both external and internal to the corporate form.[37] Externally, corporations can sue and be sued, and "[t]he traditional concept of standing confers upon the corporation the right to bring a cause of action for its own injury."[38] Internally, litigation is subsumed within the "business and affairs" of a corporation and is therefore entrusted primarily to the board of directors.[39]

B. Courts Create the Derivative Suit Mechanism

A judicially created exception to this traditional concept of standing, the derivative suit "developed in equity to enable shareholders to sue in the corporation's name where those in control of the company refused to assert a claim belonging to it."[40] Courts developed the derivative suit mechanism to hold boards

no way depends on the merits of the plaintiff's contention that particular conduct is illegal . . . ."); *see also* Whitmore v. Arkansas, 495 U.S. 149, 154 (1990) ("It is well established, however, that before a federal court can consider the merits of a legal claim, the person seeking to invoke the jurisdiction of the court must establish the requisite standing to sue."); Sierra Club v. Morton, 405 U.S. 727, 741 (1972) ("As we conclude that the Court of Appeals was correct in its holding that the Sierra Club lacked standing to maintain this action, we do not reach any other questions presented in the petition, and we intimate no view on the merits of the complaint."); *Dover Historical Soc'y*, 838 A.2d at 1110 ("The issue of standing is concerned 'only with the question of *who* is entitled to mount a legal challenge and not with the merits of the subject matter in controversy.'" (quoting *Stuart Kingston*, 592 A.2d at 1382)); *In re* Primedia, Inc. S'holders Litig., 67 A.3d 455, 477 (Del. Ch. 2013) ("[A] plaintiff . . . must first establish standing to sue. If standing exists, then the plaintiff must still plead a viable claim." (citing Parnes v. Bally Entm't Corp., 722 A.2d 1243, 1244–46 (Del. 1999))); *cf*. Del. Ct. Ch. R. 17(a) ("Every action shall be prosecuted in the name of the real party in interest.").

37. *Ala. By-Products*, 657 A.2d at 264 ("The standing doctrine has assumed special significance in the area of corporate law.").

38. Schoon v. Smith, 953 A.2d 196, 201 (Del. 2008).

39. Del. Code Ann. tit. 8, § 141(a) (2011); *see also* Spiegel v. Buntrock, 571 A.2d 767, 773 (Del. 1990) ("The decision to bring a lawsuit or to refrain from litigating a claim on behalf of a corporation is a decision concerning the management of the corporation. Consequently, such decisions are part of the responsibility of the board of directors." (citations omitted)); South v. Baker, 62 A.3d 1, 13 (Del. Ch. 2012) ("Section 141(a) vests statutory authority in the board of directors to determine what action the corporation will take with its litigation assets, just as with other corporate assets."); Agostino v. Hicks, 845 A.2d 1110, 1115–16 (Del. Ch. 2004) ("One corporate power exercised by the board of directors is the conduct of litigation that seeks to redress harm inflicted upon the corporation, including harm inflicted upon the corporation by its officers or directors from a breach of fiduciary duty owed to the corporation and its shareholders.").

40. Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984); *see also* Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, 95 (1991) ("Devised as a suit in equity, the purpose of the derivative action was to place in the hands of the individual shareholder a means to protect the interests of the corporation from the misfeasance and malfeasance of 'faithless directors and managers.'" (quoting Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 548 (1949))); Desimone v. Barrows, 924 A.2d 908, 914 (Del. Ch. 2007) ("[T]he key issue for purposes of this [Rule 23.1] motion is whether the . . . board should be divested of its authority to address th[e] misconduct."); Taormina v. Taormina Corp., 78 A.2d 473, 475 (Del. Ch. 1951) ("[W]henever a corporation possesses a cause of action which it either refuses to assert or, by reason of circumstances, is unable to assert, equity will permit a stockholder to sue in his own name for the benefit of the corporation . . . .").

accountable to stockholders.[41] Derivative actions are a vital part of the corporate governance immune system.[42]

The derivative action was created and shaped by the common law of corporations. Now, section 327 of the DGCL[43] and Court of Chancery Rule 23.1[44] play a limiting role, restricting derivative standing to those stockholders who satisfy certain technical requirements. Fewer stockholders who have derivative standing means fewer derivative actions. Fewer monitors means less monitoring. As a result, section 327 and Rule 23.1 generally impede the deterrence function of the derivative suit mechanism.

C. Standing Doctrines Develop for Direct and Derivative Actions

Stockholder litigation takes two basic forms: direct actions brought by stockholders on their own behalf, and derivative actions brought by stockholders on behalf of corporations.[45] To determine whether a claim is direct or derivative,

41. *Schoon*, 953 A.2d at 201 ("The equitable standing of a stockholder to bring a derivative action on behalf of a corporation has long been grounded upon the interests of justice."); *see* Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1036 (Del. 2004) ("The derivative suit has been generally described as 'one of the most interesting and ingenious of accountability mechanisms for large formal organizations.'" (quoting Kramer v. W. Pac. Indus., Inc., 546 A.2d 348, 351 (Del. 1988))); Rales v. Blasband, 634 A.2d 927, 932 (Del. 1993) ("The stockholder derivative suit is an important and unique feature of corporate governance."); Seinfeld v. Coker, 847 A.2d 330, 333 (Del. Ch. 2000) ("It is important for shareholders to bring derivative suits because these suits, filed after the alleged wrongdoing, operate as an *ex post* check on corporate behavior."); *see also* Surowitz v. Hilton Hotels Corp., 383 U.S. 363, 371 (1966) ("[D]erivative suits have played a rather important role in protecting shareholders of corporations from the designing schemes and wiles of insiders who are willing to betray their company's interests in order to enrich themselves."); *Cohen*, 337 U.S. at 548 ("This remedy [i.e., a derivative action] born of stockholder helplessness was long the chief regulator of corporate management and has afforded no small incentive to avoid at least grosser forms of betrayal of stockholders' interests. It is argued, and not without reason, that without it there would be little practical check on such abuses."); Hawes v. City of Oakland, 104 U.S. 450, 453 (1881) ("That the vast and increasing proportion of the active business of modern life which is done by corporations should call into exercise the beneficent powers and flexible methods of courts of equity, is neither to be wondered at nor regretted; and this is especially true of controversies growing out of the relations between the stockholder and the corporation of which he is a member. The exercise of this power in protecting the stockholder against the frauds of the governing body of directors or trustees, and in preventing their exercise, in the name of the corporation, of powers which are outside of their charters or articles of association, has been frequent, and is most beneficial, and is undisputed.").

42. *See* Daniel J. Dykstra, *The Revival of the Derivative Suit*, 116 U. Pa. L. Rev. 74, 78 (1967) ("[D]ay in and day out, the derivative action plays the role of 'corporate policeman.' There may be substitutes for the derivative suit, but so far none has been introduced that could be effectively implemented."); *see also* Brendle v. Smith, 46 F. Supp. 522, 526 (S.D.N.Y. 1942) ("The measure of effectiveness of the stockholder's derivative suit cannot be taken by a computation of the money recovery in the litigated cases. The minatory effect of such actions has undoubtedly prevented diversion of large amounts from stockholders to managements and outsiders. Corporate attorneys now have an arsenal of authorities to support their cautioning advice to clients who may be disposed to risk evasion of the high standard the courts have imposed upon directors.").

43. Del. Code Ann. tit. 8, § 327 (2011).

44. Del. Ct. Ch. R. 23.1(a).

45. *See generally Tooley*, 845 A.2d at 1033 (discussing the "direct vs. derivative dichotomy"). To complicate the matter, "[c]ourts have long recognized that the same set of facts can give rise

"[t]he analysis must be based solely on the following [two] questions."[46] First, "[w]ho suffered the alleged harm—the corporation or the suing stockholder individually?"[47] And second, "who would receive the benefit of the recovery or other remedy?"[48]

1. Stockholder Standing in Direct Actions Is Straightforward and Easy

Classifying a stockholder action as direct is practically conclusive as to standing. In a direct action, traditional standing principles apply, requiring a plaintiff to establish an injury-in-fact, caused by the conduct complained of and redressible by the court in the litigation.[49] These requirements dovetail with *Tooley's* definition of a direct action as one in which the stockholders suffered harm and would receive the benefit of any recovery.[50] Accordingly, in a direct action, standing is straightforward.

2. Stockholder Standing in Derivative Actions Is More Complex and Difficult to Establish

Classifying an action as derivative under *Tooley* only begins the standing analysis. A derivative plaintiff must surpass three additional obstacles. One is imposed by section 327 of the DGCL, another by the common law, and the third by Court of Chancery Rule 23.1.

a. The Contemporaneous Ownership Requirement

Under the contemporaneous ownership requirement, a derivative plaintiff must allege "that the plaintiff was a stockholder of the corporation at the time of the transaction of which such stockholder complains or that such stockholder's stock thereafter devolved upon such stockholder by operation of law."[51] Section 327 of the DGCL, which codified the contemporaneous ownership requirement, "w[as] enacted solely 'to prevent what has been considered an evil, namely, the purchasing of shares in order to maintain a derivative action designed to attack a transaction which occurred prior to the purchase of the

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to both a direct claim and a derivative claim." Grimes v. Donald, 673 A.2d 1207, 1212 (Del. 1996).

46. *Tooley*, 845 A.2d at 1035.

47. *Id.*

48. *Id.*

49. *In re* Celera Corp. S'holder Litig., 59 A.3d 418, 429 (Del. 2012); *see also* Oceanport Indus., Inc. v. Wilmington Stevedores, Inc., 636 A.2d 892, 904 (Del. 1994) (adopting standing test applied in federal courts as set forth by *Lujan v. Defenders of Wildlife*, 504 U.S. 555 (1992)).

50. *Tooley*, 845 A.2d at 1035.

51. Del. Code Ann. tit. 8, § 327 (2011); *see* Del. Ct. Ch. R. 23.1(a) ("In a derivative action . . . the complaint shall allege that the plaintiff was a shareholder or member at the time of the transaction of which the plaintiff complains or that the plaintiff's share . . . thereafter devolved upon the plaintiff by operation of law."); *see also* Parfi Holding AB v. Mirror Image Internet, Inc., 954 A.2d 911, 937 (Del. Ch. 2008).

stock.'"[52] And "while the statute should be construed so as to reasonably effectuate its primary purpose—to discourage a type of strike suit—it should not be construed so as to unduly encourage the camouflaging of transactions and thus prevent reasonable opportunities to rectify corporate aberrations."[53] The contemporaneous ownership requirement is nonetheless applied as a black-letter rule, without regard to an individual stockholder's knowledge of the facts giving rise to the alleged claims, to limit the number of stockholders who have derivative standing.

The rule applies therefore without regard for its intent-based legislative purpose. This helpfully makes the rule clear and predictable, but the cost for its predictability is its over-inclusiveness. Accordingly, the rule hinders the vitality of the derivative action as an accountability mechanism more than would be necessary to fulfill its purposes; it paints with a broom where an ordinary paint brush would do.

Each trading day following corporate misconduct, shares of the corporation's stock change hands. As stockholders trade out of their positions, the number of potential derivative plaintiffs declines, making it less likely that the misconduct will ever be redressed. When the corporation remains independent, shares change hands gradually in a series of voluntary transactions with presumably willing sellers. The opposite is true in a merger, where a corporation can effectively eliminate all potential derivative plaintiffs in one fell swoop. Still, by section 327's literal terms, the contemporaneous ownership requirement generally precludes a stockholder of the acquiror from asserting post-merger derivative claims that once belonged to the target.[54]

b. The Continuous Ownership Requirement

Under the continuous ownership requirement, "[a] plaintiff who ceases to be a shareholder, whether by reason of a merger or for any other reason, loses standing to continue a derivative suit."[55] Unlike the contemporaneous ownership requirement, which has been given the heft of statutory law, the continuous ownership requirement remains a judge-made creature of equity.[56]

52. Schoon v. Smith, 953 A.2d 196, 203 (Del. 2008) (quoting Rosenthal v. Burry Biscuit Corp., 60 A.2d 106, 111 (Del. Ch. 1948)); *accord* Jones v. Taylor, 348 A.2d 188, 191 (Del. Ch. 1975) ("[I]t is well recognized that [section 327] was enacted to eliminate strike suits and other abuses which developed along with the derivative suit."); Maclary v. Pleasant Hills, Inc., 109 A.2d 830, 833 (Del. Ch. 1954) ("This statute . . . was designed principally to prevent the purchasing of stock to be used for the purpose of filing a derivative action attacking transactions occurring prior to such purchase.").

53. *Maclary*, 109 A.2d at 833.

54. Del. Code Ann. tit. 8, § 327. This assumes that the stockholders of the acquiror are not also stockholders of the target who would satisfy the literal terms of section 327 by reason other than their ownership of the acquiror's stock.

55. Lewis v. Anderson, 477 A.2d 1040, 1049 (Del. 1984).

56. *See In re* New Valley Corp. Derivative Litig., C.A. No. 17649-NC, 2004 WL 1700530, at *3 (Del. Ch. June 28, 2004) ("Although section 327 does not explicitly require continuous stock ownership to maintain a derivative action, that requirement has been a staple of Delaware law for over two decades."); *but see* Rosen v. Navarre, C.A. No. 7098, 1985 WL 21155, at *3 (Del. Ch. Oct. 29, 1985) ("In reaching its decision that a plaintiff must remain a stockholder throughout the litigation, the

This rule is designed to ensure that representative litigants have proper economic incentives. Because recovery in a derivative suit goes to the corporation,[57] a potential derivative plaintiff's economic interest in the litigation is coterminous with the would-be plaintiff's stock ownership.[58] And, as with contemporaneous ownership, the pool of stockholders with continuous ownership evaporates as the corporation's stock is traded in the market following a corporate transaction, thereby limiting the number of potential derivative plaintiffs.

Again, when a corporation remains independent, stockholders who sell their shares (and with them, their derivative standing) do so voluntarily and in one-off transactions. The opposite is true in a merger, when the corporation imposes a one-time divestiture that, as to any particular stockholder, may not be desirable. Still, "a merger which eliminates a complaining stockholder's ownership of stock in a corporation also ordinarily eliminates his status to bring or maintain a derivative action on behalf of the corporation, whether the merger takes place before or after the suit is brought, on the theory that upon the merger the derivative rights pass to the surviving corporation which then has the sole right or standing to prosecute the action."[59]

c. *The Demand Requirement*

If the board's statutory authority to control corporate litigation has meaning, stockholders cannot wrest it away on a whim.[60] On the heels of the development of the derivative suit, the courts developed the demand requirement to balance authority and accountability within the corporation.[61] Generally speaking, a stockholder is required to make a litigation demand on the board before filing suit, except where a majority of the board is interested in the challenged trans-

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Delaware Supreme Court . . . recently held that 8 *Del. C.* §§ 259, 261 and 327 read individually and collectively mean that a plaintiff who ceases to be a stockholder loses his standing to maintain his stockholder's derivative suit.").

57. Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1035 (Del. 2004).

58. *See, e.g.*, Ala. By-Products Corp. v. Cede & Co., 657 A.2d 254, 265 (Del. 1995) ("Once the derivative plaintiff ceases to be a stockholder in the corporation on whose behalf the suit was brought, he no longer has a financial interest in any recovery pursued for the benefit of the corporation."); *see also* Portnoy v. Kawecki Berylco Indus., Inc., 607 F.2d 765, 767 (7th Cir. 1979) ("The underlying rationale of these cases is that because a shareholder will receive at least an indirect benefit (in terms of increased shareholder equity) from any corporate recovery, he has an adequate interest in vigorously litigating the claim. A non-shareholder or one who loses his shareholder interest during the course of the litigation may lose any incentive to pursue the litigation adequately.").

59. Schreiber v. Carney, 447 A.2d 17, 21 (Del. Ch. 1982).

60. Levine v. Smith, 591 A.2d 194, 200 (Del. 1991) ("Under Delaware law, a derivative suit is . . . a qualified or conditional remedy by reason of its 'potential for conflict between the directors' power to manage the corporation and the shareholders' power to sue derivatively.'" (quoting Kaplan v. Peat, Marwick, Mitchell & Co., 540 A.2d 726, 730 (Del. 1988))).

61. Cochran v. Stifel Fin. Corp., C.A. No. 17350, 2000 WL 286722, at *10 n.41 (Del. Ch. Mar. 8, 2000) ("As a historical matter, . . . it appears that the derivative suit was a common law development designed to ensure basic fairness and that the demand requirement was judicially created to guarantee that the statutory power of directors to manage the legal affairs of the company was not disregarded except when necessary to serve the policy purpose justifying the recognition of the derivative suit in the first instance.").

action, lacks independence, or faces a substantial risk of liability.[62] The demand requirement thus protects the board's paramount role in the management of the business and affairs of the corporation, but it also limits the number and kind of derivative cases that can survive the pleadings stage.[63]

D. A Merger Complicates Questions About Standing

As foreshadowed by the continuous ownership requirement, the general rule, set forth by the Delaware Supreme Court nearly thirty years ago in *Lewis v. Anderson*,[64] is that "[a] plaintiff who ceases to be a shareholder, whether by reason of a merger or for any other reason, loses standing to continue a derivative suit."[65] *Anderson* recognizes two equitable exceptions to this. A plaintiff's equitable standing to prosecute derivative claims will survive a merger, thereby outlasting the plaintiff's stock ownership: "(1) where the merger itself is the subject of a claim of fraud; and (2) where the merger is in reality a reorganization which does not affect plaintiff's ownership of the business enterprise."[66] These exceptions are narrowly circumscribed.

To invoke successfully the fraud exception would all but require the proverbial smoking gun. It applies only where the "sole basis for [the target corporation's] decision to enter the merger was to divest the plaintiff of derivative

62. *See generally* Rales v. Blasband, 634 A.2d 927, 933–34 (Del. 1993) (where the board did not make a business decision that is the subject of the underlying litigation, demand futility test requires the court "to examine whether the board that would be addressing the demand can impartially consider its merits without being influenced by improper considerations"); Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984) ("[I]n determining demand futility the Court of Chancery in the proper exercise of its discretion must decide whether, under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment."); *see also In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 939 (Del. Ch. 2003) ("Under Delaware law, the primary means by which corporate defendants may obtain a dismissal of a derivative suit is by showing that the plaintiffs have not met their pleading burden under the test of *Aronson v. Lewis*, or the related standard set forth in *Rales v. Blasband*. In simple terms, these tests permit a corporation to terminate a derivative suit if its board is comprised of directors who can impartially consider a demand."); Guttman v. Huang, 823 A.2d 492, 501 (Del. Ch. 2003) ("At first blush, the *Rales* test looks somewhat different from *Aronson*, in that [it] involves a singular inquiry. . . . Upon closer examination, however, that singular inquiry makes germane all of the concerns relevant to both the first and second prongs of *Aronson*.").

63. *See* Robert B. Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative Lawsuits*, 57 Vand. L. Rev. 1747, 1786–87 (2004) (recognizing that futility standard, in conjunction with increasingly independent boards of directors, "have cast doubt on the continued viability of the public company derivative suit"). The futility standard must also be read in conjunction with the power of independent directors to terminate unwanted derivative litigation on the ground that it is not in the best interests of the corporation. *See generally* Burks v. Lasker, 441 U.S. 471 (1979); Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981). Leading commentators decried this development as the death knell for the derivative action. *See generally* Coffee & Schwartz, *supra* note 25.

64. 477 A.2d 1040 (Del. 1984). *Anderson* was recently "ratif[ied] and reaffirm[ed]" by the Delaware Supreme Court in September 2013 in the latest chapter of the Countrywide cases. *See* Ark. Teacher Ret. Sys. v. Countrywide Fin. Corp., 75 A.3d 888, 890 (Del. 2013); *see also id.* at 897 ("*Lewis v. Anderson* is settled Delaware law and has been consistently followed since 1984." (footnote omitted)).

65. *Anderson*, 477 A.2d at 1049.

66. *Id.*

standing."[67] Under this "sole purpose" test, the fraud exception does not apply except in the yet-unseen case that a merger is "pretextual," with "no alternative valid business purpose" other than to extinguish standing.[68]

The reorganization exception applies only to cases in which the merger changes neither the economic structure nor ownership profile of the corporation.[69] As a consequence, the reorganization exception does not apply to "mergers with outside or pre-existing corporations with substantial assets."[70]

E. Stockholder Plaintiffs Find Paths Around *Anderson*

1. Stock-for-Stock Mergers Make Double-Derivative Actions Possible

Aside from the *Anderson* exceptions, another, more useful way that a stockholder plaintiff can establish derivative standing following a merger is by pleading a double-derivative claim on behalf of the acquiror. Section 259 of the DGCL provides that all the rights, privileges, powers, and property of the target corporation shall become vested in the surviving or resulting corporation at the effective time of a merger.[71] Thus, whether the transaction is structured as a two-

67. Lewis v. Ward, C.A. No. 15225, 2003 WL 22461894, at *5 (Del. Ch. Oct. 29, 2003), *aff'd*, 852 A.2d 896 (Del. 2004); *see also* Kramer v. W. Pac. Indus., Inc., 546 A.2d 348, 354 (Del. 1988) (fraud exception applies only where merger is "being perpetrated merely to deprive shareholders of the standing to bring a derivative action"); Globis Partners, L.P. v. Plumtree Software, Inc., C.A. No. 1577-VCP, 2007 WL 4292024, at *8 (Del. Ch. Nov. 30, 2007).

68. *Globis Partners*, 2007 WL 4292024, at *8. Chancellor Allen and Vice Chancellor Laster took a slightly broader view of the exception, twenty-four years apart, applying a "principal purpose" test instead. Brinckerhoff v. Tex. E. Prods. Pipeline Co., 986 A.2d 370, 383 (Del. Ch. 2010) (Laster, V.C.) (applying a "principal purpose" test: "The facts here readily support the inference that eliminating the Derivative Action was a principal purpose for the Merger, albeit not the only purpose."); Merritt v. Colonial Foods, Inc., 505 A.2d 757, 763 & n.3 (Del. Ch. 1986) (Allen, C.) (finding "principal purpose" test satisfied, but holding that fraud exception should be excised from the law: "The logic of the derivative form of action compels that result.").

69. *See, e.g.*, Lewis v. Ward, 852 A.2d 896, 904 (Del. 2004) ("The 'mere organization exception' of *Lewis v. Anderson* has no applicability to this case. Amax Gold and Kinross were two distinct corporations, each with its own board of directors, officers, assets and stockholders. In this case, as in *Bonime v. Biaggini*, the Kinross Merger was far more than a corporate reshuffling."); Bonime v. Biaggini, C.A. Nos. 6925, 6980, 1984 WL 19830, at *3 (Del. Ch. Dec. 7, 1984) ("Here SPSF . . . is the result of a merger of two distinct corporations each of which had separate boards, officers, assets and stockholders. . . . SPFS is distinctly different from either of its constituent corporations, Southern Pacific or Santa Fe. . . . In short, the entire corporate mix is distinctly different from that of Southern Pacific as it existed when plaintiffs' claim arose. As a consequence the shares held by plaintiffs represent property interests also distinctly different from that which they held as shareholders of Southern Pacific. They thereupon have lost standing to maintain this derivative litigation."), *aff'd*, 505 A.2d 451 (Del. 1985).

70. Schreiber v. Carney, 447 A.2d 17, 22 (Del. Ch. 1982); *see also Ward*, 852 A.2d at 904 ("Amax Gold and Kinross were two distinct corporations, each with its own board of directors, officers, assets and stockholders. . . . [T]he Kinross Merger was far more than a corporate reshuffling."); *Bonime*, 1984 WL 19830, at *3 (reorganization exception inapplicable where merger involves "two distinct corporations" with "separate boards, officers, assets, and stockholders," and where post-merger entity's "entire corporate mix is distinctly different" from the pre-merger entity in which plaintiff held stock).

71. Del. Code Ann. tit. 8, § 259(a) (2011); *see also Kramer*, 546 A.2d at 355 ("Title to such claims has passed by operation of law to [the acquiror], and [the acquiror] alone has the right to determine whether to pursue such claims against the defendants."). More precisely, in a direct, two-party

party merger in which the target merges into the acquiror, or a reverse triangular merger in which the target survives as a wholly owned subsidiary of the acquiror, control of the pre-merger derivative claims that once belonged to the target corporation vests in the acquiror.[72] And in the case of a stock-for-stock merger, "where the [acquiror's] board is shown to be incapable of deciding impartially whether or not to enforce the claim[s]," the pre-merger target stockholders may prosecute derivative claims once belonging to the target on the acquiror's behalf.[73]

As a practical matter, this provides cold comfort for stockholders because the post-merger board of the acquiror often will be independent from the pre-merger board of the target, thereby negating demand futility.[74] Stockholder plaintiffs are left to make a litigation demand, and then to plead claims based on a board's wrongful refusal of demand. This path so often leads to business judgment rule dismissal, as it should.[75]

2. Derivative Claims Give Rise to Merger Challenges

The more logical course around *Anderson* was charted by the Delaware Supreme Court in 1999 in *Parnes v. Bally Entertainment Corp.*,[76] but has largely lay dormant since. *Parnes* makes it possible for a once-derivative plaintiff to challenge a merger directly when it eliminates the plaintiff's derivative standing.[77]

merger, section 259(a) provides that technical ownership and control of the target's derivative claims passes to the acquiror. *See* DEL. CODE ANN. tit. 8, § 259(a). In a triangular merger in which the "surviving or resulting corporation" is a wholly owned subsidiary of the acquiror, section 259(a) provides that technical ownership and control of the target's derivative claims passes to the acquiror's wholly owned subsidiary. Hamilton Partners, L.P. v. Englard, 11 A.3d 1180, 1205 (Del. Ch. 2010). However, because of "the practical ability of the sole stockholder [i.e., the acquiror] to exercise control over the subsidiary," effective control over the wholly owned subsidiary's derivative claim, with or without technical ownership of or statutory authority over it, resides with the parent [i.e., acquiring] corporation's board of directors. Lambrecht v. O'Neal, 3 A.3d 277, 282 (Del. 2010); *Hamilton Partners*, 11 A.3d at 1202–07 (discussing *Lambrecht*).

72. *Lambrecht*, 3 A.3d at 282; *Hamilton Partners*, 11 A.3d at 1202–07.

73. *Lambrecht*, 3 A.3d at 290; *see also id.* at 288 (citing *Ward*, 852 A.2d at 906) (Delaware law "not only validate[s] but also encourage[s] the bringing of double derivative actions in cases where standing to maintain a standard derivative action is extinguished as a result of an intervening merger."); *Hamilton Partners*, 11 A.3d at 1206 ("The Delaware Supreme Court's decision in *Lambrecht* to permit a plaintiff to proceed with a double derivative action post-merger should be regarded as a resoundingly pro-stockholder ruling that is consistent with Delaware public policy.").

74. *In re* Massey Energy Co. Derivative & Class Action Litig., C.A. No. 5430-VCS, 2011 WL 2176479, at *2 (Del. Ch. May 31, 2011) ("Although that is a possibility, it is not one that an objective mind ought to consider probable, given that the [acquiror's] board has no exposure to liability for the Derivative Claims and the myriad of rational business reasons why [the acquiror] may later decide that prosecuting those Claims does or does not make sense for [it] as a corporation.").

75. *See* Spiegel v. Buntrock, 571 A.2d 767, 775–76 (Del. 1990) ("A shareholder who makes a demand can no longer argue that demand is excused. The effect of a demand is to place control of the derivative litigation in the hands of the board of directors. Consequently, stockholders who . . . make a demand which is refused, subject the board's decision to judicial review according to the traditional business judgment rule.").

76. 722 A.2d 1243 (Del. 1999).

77. *See generally Parnes*, 722 A.2d at 1245; *In re* Primedia, Inc. S'holders Litig., 67 A.3d 455 (Del. Ch. 2013).

"A plaintiff claiming standing to challenge a merger directly under *Parnes* because of a board's alleged failure to obtain value for an underlying derivative claim must meet a three part test."[78] As applied by the Court of Chancery in *Primedia*, the *Parnes* test states:

> First, the plaintiff must plead an underlying derivative claim that has survived a motion to dismiss or otherwise could state a claim on which relief could be granted. Second, the value of the derivative claim must be material in the context of the merger. Third, the complaint challenging the merger must support a pleadings-stage inference that the acquirer would not assert the underlying derivative claim and did not provide value for it.[79]

Only if a plaintiff satisfies all three parts of this test will the court address whether or not the complaint states a claim.[80]

II. Exploring the Infirmities of the Current System

The set of legal rules that governs standing in the wake of a merger has fallen into disrepair. There are many observable symptoms of this, but three root causes have emerged: (1) the *Parnes* test, (2) the *Anderson* exceptions, and (3) the contemporaneous ownership requirement as applied to post-merger suits by stockholders of the acquiror.

A. The Problems Caused by *Parnes*

The *Parnes* test undermines core principles of Delaware law and public policy. The doctrinal problems caused by the *Parnes* test begin with its fundamental incoherence.

In a merger, the acquiror takes from the target corporation all of its "rights, privileges, powers and franchises," as well as its "property, real, personal and mixed, and all debts due to [it]."[81] In exchange, the acquiror pays the target stockholders "cash, property, rights or securities of any other corporation or entity."[82] If this exchange does not compensate the stockholders adequately for almost any reason, then the stockholders may challenge the merger directly in a

78. *Primedia*, 67 A.3d at 477.

79. *Id.*; *see also Massey Energy*, 2011 WL 2176479, at *21 ("[C]andor requires acknowledging that the plaintiffs have likely pled Derivative Claims that would survive a motion to dismiss, even under the heightened pleading standard applicable under Rule 23.1."); *id.* at *28 ("In this regard, I also note the absence of any substantial argument from the plaintiffs that the Derivative Claims are really of material value in the context of a transaction like the Alpha Merger."); *id.* at *26 ("The record does not support an inference that Alpha has made any commitment to Massey Board members not to pursue the Derivative Claims if that is in Alpha's best interest.").

80. *Primedia*, 67 A.3d at 485–86; *see also Parnes*, 722 A.2d at 1246 ("Although we conclude that the Parnes complaint directly challenges the Bally merger, it does not necessarily follow that the complaint adequately states a claim for relief.").

81. Del. Code Ann. tit. 8, § 259(a) (2011).

82. *Id.* § 251(b); *see also id.* § 253 (providing, in a short form merger, for payment of "securities, cash, property, or rights").

suit against the members of the board of directors.[83] But if the merger exchange does not compensate the stockholders adequately for one specific reason—that it provides inadequate value for a derivative claim—then the plaintiffs must clear three additional hurdles to have standing to sue.[84]

This is an incongruous result. A derivative claim is an asset of the corporation.[85] Corporate directors have a fiduciary duty, rooted in the same "old trust principles"[86] as the *Revlon* doctrine, to maximize the value of corporate assets for the benefit of the stockholders.[87] This is a contextual application of the duties

83. *See, e.g.*, Donald F. Parsons, Jr. & Jason S. Tyler, *Docket Dividends: Growth in Shareholder Litigation Leads to Refinement in Chancery Procedures*, 70 WASH. & LEE L. REV. 473, 514 (2013) ("For example, when corporate directors breach their fiduciary duty in the context of a merger, the breach generally harms shareholders directly by divesting them of their stock ownership. For that reason, the shareholders themselves have a claim that they can bring directly against the board and other corporate fiduciaries."); *see also In re* Celera Corp. S'holder Litig., 59 A.3d 418, 430 (Del. 2012) (stockholders at the time a merger agreement is signed generally have standing to challenge the merger).

84. *Primedia*, 67 A.3d at 477 ("A plaintiff claiming standing to challenge a merger directly under *Parnes* because of a board's alleged failure to obtain value for an underlying derivative claim must meet a three part test.").

85. Bomarko, Inc. v. Int'l Telecharge, Inc., C.A. No. 13052, 1994 WL 198726, at *3 (Del. Ch. May 16, 1994) ("[B]reach of fiduciary duty claims that do not arise from the merger are corporate assets that may be included in the determination of fair value . . . ."); Porter v. Tex. Commerce Bancshares, Inc., C.A. No. 9114, 1989 WL 120358, at *5 (Del. Ch. Oct. 12, 1989) ("A merger in which a corporation's shareholders received stock in another corporation, other securities or cash, will always result in termination of the right of the pre-merger shareholders to sue on behalf of the company. . . . If the company has substantial and valuable derivative claims, they, like any asset of the company, may be valued in an appraisal."); *see also* Nagy v. Bistricer, 770 A.2d 43, 55–56 (Del. Ch. 2000) (similar); Gonsalves v. Straight Arrow Publishers, Inc., C.A. No. 8474, 1996 WL 483093, at *1 n.1 (Del. Ch. Aug. 22, 1996) (noting complexity of determining and applying net settlement value of corporation-owned claims as assets of the corporation in appraisal action). As the cases cited in this footnote suggest, the appraisal remedy is one avenue available to target stockholders seeking just compensation for their share of the corporation's legal claims. But the appraisal remedy is, at best, an incomplete substitute for the right to proceed with a plenary equitable action. *See, e.g.*, Cede & Co. v. Technicolor, Inc., 542 A.2d 1182, 1187–88 (Del. 1988) ("[I]n a section 262 appraisal action the only litigable issue is the determination of the value of the appraisal petitioners' shares on the date of the merger, the only party defendant is the surviving corporation and the only relief available is a judgment against the surviving corporation for the fair value of the dissenters' shares. In contrast, a fraud action asserting fair dealing and fair price claims affords an expansive remedy and is brought against the alleged wrongdoers to provide whatever relief the facts of a particular case may require."); Weinberger v. UOP, Inc., 457 A.2d 701, 714 (Del. 1983) ("The appraisal remedy . . . may not be adequate in certain cases, particularly where fraud, misrepresentation, self-dealing, deliberate waste of corporate assets, or gross and palpable overreaching are involved."). Among other things, one "apparent inadequac[y]" of an appraisal action is that an appraisal petitioner "does not get to represent a class and thus neither do her attorneys." Andra v. Blount, 772 A.2d 183, 194 (Del. Ch. 2000). "In a class action, the plaintiff's lawyers can take their fees and expenses against any class-wide recovery, whereas in an appraisal action the fees and expenses can be recovered only as an offset against the appraisal award to the usually far smaller group of stockholders who perfected their appraisal rights." *Id.*; *see also* Randall S. Thomas, *Revising the Delaware Appraisal Statute*, 3 DEL. L. REV. 1, 27–28 (2000) ("Although the named petitioner can spread its costs of prosecuting an appraisal action over the entire group of shareholders seeking appraisal, and thereby pay only a portion of the total costs of the action, a small shareholder will only find an appraisal petition cost-justified where many thousands of shares are also seeking this remedy."). As a result, the statutory appraisal remedy is an unsatisfying solution to the problems this article seeks to address.

86. *In re* Toys "R" Us, Inc. S'holder Litig., 877 A.2d 975, 999 (Del. Ch. 2005).

87. *See generally* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986); *see also* Forsythe v. ESC Fund Mgmt. Co. (U.S.), C.A. No. 1091-VCL, 2013 WL 458373, at *2 n.3 (Del. Ch. Feb. 6, 2013) ("Although the value-maximizing principle is typically associated with

of care and loyalty in the sale of other people's property.[88] Litigation assets should be no different.[89]

1. *Parnes* Creates a Safe Harbor Where Fiduciaries Are Accountable to No One

Apart from its incoherence, the three-part *Parnes* test permits fiduciaries to avoid accountability for their misdeeds. It creates a dangerous loophole that could effectively transfer wealth into the pockets of faithless fiduciaries and out of the coffers of the Delaware corporations to which those fiduciaries have pledged their allegiance.

Outside of cases governed by *Parnes*, in recognition of "abuses in the settlement of derivative actions,"[90] derivative actions may not end without judicial approval.[91] This is to prevent a situation "where corporate actions would simply

Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986), it is not unique to that context."); Paramount Commc'ns Inc. v. Time, Inc., C.A. Nos. 10866, 10670, 10935, 1989 WL 79880, at *25 (Del. Ch. July 14, 1989) ("*Revlon* was not a radical departure from existing . . . law (i.e., it has 'always' been the case that when a trustee or other fiduciary sells an asset for cash, his duty is to seek the single goal of getting the best available price . . . .")), *aff'd*, 571 A.2d 1140 (Del. 1989).

88. *See, e.g.*, Edgewater Growth Capital Partners, L.P. v. H.I.G. Capital, Inc., C.A. No. 3601-VCS, 2010 WL 720150, at *3 n.18 (Del. Ch. Mar. 3, 2010) ("Corporate directors already face liability to the corporation for breach of fiduciary duty if they knowingly cause the corporation to sell its assets for less than fair value."); *Paramount Commc'ns*, 1989 WL 79880, at *25; Robinson v. Pittsburgh Oil Ref. Corp., 126 A. 46, 49 (Del. Ch. 1924) ("Where the standard of comparison is the absolute one of dollars in hand for the same identical thing, a discretion which would choose the smaller amount would be so manifestly abused as to convict itself of fraud."); Leo E. Strine, Jr., *Categorical Confusion: Deal Protection Measures in Stock-for-Stock Merger Agreements*, 56 Bus. Law. 919, 927 n.25 (2001) ("The *Revlon* principle grows out of the traditional principle that fiduciaries must sell trust assets for their highest value."); J. Travis Laster, *Exposing a False Dichotomy: The Implications of the No-Talk Cases for the* Time/Revlon *Double Standard*, 3 Del. L. Rev. 179, 206 (2000) (same).

89. *Primedia*, 67 A.3d at 486 ("'Any board negotiating the sale of a corporation should attempt to value and get full consideration for all of the corporation's material assets,' including litigation assets." (quoting *In re* Massey Energy Co. Derivative & Class Action Litig., C.A. No. 5430-VCS, 2011 WL 2176479, at *3 (Del. Ch. May 31, 2011))). The disparate treatment of litigation assets was not a conscious creation, but rather a byproduct of courts' reluctance to accept the notion that a merger could transmogrify classically derivative causes of action into direct claims. *See* Kramer v. W. Pac. Indus., Inc., 546 A.2d 348, 354 (Del. 1988) ("Kramer's position is tantamount to saying that, in the context of a cash-out merger, whenever a shareholder asserts a claim against management for breach of fiduciary duty based upon waste or other acts causing a monetary loss to the corporation, the shareholder's claim should also be construed: (i) as asserting a 'special injury' to the shareholder, as distinct from the corporation; and (ii) as amounting to a *direct* attack on the terms of the merger, thus giving the shareholder standing to continue, or bring forward, a suit after merger. Such a position is contrary to well-established principles of Delaware law and cannot be accepted by this Court.").

90. Lamb v. Seiberling Rubber Co., C.A. No. 1416, 1961 WL 62172, at *1 (Del. Ch. Sept. 18, 1961); *see also* Velhi, Inc. v. PSA, Inc., C.A. No. 5730, 1980 WL 3033, at *2 (Del. Ch. Mar. 6, 1980) ("Rule 23.1 was adopted . . . for the overall purpose of insuring judicial supervision over derivative actions, thereby preventing abuses in the disposal of such litigation . . . .").

91. Del. Ct. Ch. R. 23.1(c) ("The action shall not be dismissed or compromised without the approval of the Court, and notice by mail, publication or otherwise of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the Court directs."); Zapata Corp. v. Maldonado, 430 A.2d 779, 789 (Del. 1981) ("The second step provides, we believe, the essential key in striking the balance between legitimate corporate claims as expressed in a derivative stockholder suit and a corporation's best interests as expressed by an independent investigating

prematurely terminate a stockholder grievance deserving of further consideration in the corporation's interest."[92] *Parnes* sets a different "balancing point where bona fide stockholder power to bring corporate causes of action cannot be unfairly trampled on by the board of directors, but the corporation can rid itself of detrimental litigation."[93]

The materiality element of the *Parnes* test is particularly dangerous as applied to stockholders of large corporations. If the CEO of a $20 billion corporation could find a friendly merger partner, she could pay herself a one-time bonus of up to $250 million with impunity, knowing that the $250 million derivative claim against her would be immaterial in the context of a merger of that magnitude.[94] Likewise, if a $5 billion corporation is offered a lucrative corporate opportunity worth $50 million, a controlling stockholder could usurp the opportunity for himself before buying out the minority at a $50 million discount. In either case, a stockholder challenging the merger would lack standing.[95] In other words, the stockholders lose for reasons unrelated to the merits of the claims and defenses. This dampens the incentives for effective stockholder monitoring and, as a second-order effect, dampens the incentives for good fiduciary behavior.[96]

The *Parnes* test has created a perverse safe harbor, up to whatever amount would be material in the context of a merger (the conservative going rate is approximately 1 percent of the merger price).[97] If fiduciaries get sued derivatively

committee. The Court should determine, applying its own independent business judgment, whether the motion should be granted."); Merritt v. Colonial Foods, Inc., 505 A.2d 757, 765 (Del. Ch. 1986) ("What is inflexible in our corporate law is the requirement that self-dealing fiduciaries deal with the corporation and its shareholders only on terms that are entirely fair. Accordingly, only where there exists a basis for a reviewing court to conclude that this supervening equitable obligation has been satisfied and that therefore a cash-out merger effectuated for the purpose of terminating pending derivative litigation does not constitute a breach of trust, will a cash-out merger provide an appropriate alternative to the *Maldonado* procedure.").

92. *Zapata*, 430 A.2d at 789.

93. *Id.* at 787; *see also Merritt*, 505 A.2d at 765 ("Accordingly, only where there exists a basis for a reviewing court to conclude that this supervening equitable obligation has been satisfied and that therefore a cash-out merger effectuated for the purpose of terminating pending derivative litigation does not constitute a breach of trust, will a cash-out merger provide an appropriate alternative to the [*Zapata*] procedure.").

94. *Massey Energy*, 2011 WL 2176479, at *28 ("[T]he total amount of applicable coverage . . . is $95 million, which is not a trifle but is also not material in the context of an $8.5 billion Merger." (footnote omitted)).

95. *In re* Primedia, Inc. S'holders Litig., 67 A.3d 455, 482 (Del. Ch. 2013) ("A plaintiff claiming standing to challenge a merger directly under *Parnes* because of a board's alleged failure to obtain value for an underlying derivative claim must meet a three part test. . . . [T]he value of the derivative claim must be material in the context of the merger.").

96. *See* Hamilton Partners, L.P. v. Englard, 11 A.3d 1180, 1206 (Del. Ch. 2010) ("[T]he risk that a plaintiff would invest resources in a viable claim only to lose standing through a merger disincentivizes stockholders from engaging in monitoring under circumstances where it is already 'likely that in a public corporation there will be less shareholder monitoring expenditures than would be optimum from the point of the shareholders as a collectivity.'" (quoting Bird v. Lida, Inc., 681 A.2d 399, 403 (Del. Ch. 1996))).

97. *Massey Energy*, 2011 WL 2176479, at *28 ("$95 million . . . is not a trifle but is also not material in the context of an $8.5 billion Merger." (footnote omitted)). Lest this amount seem trivial, it dwarfs the aggregate recovery by stockholders in three of their headline class action victories of recent

for less than that amount, they know that they can always put the company up for sale, find an acquiror that is unlikely to assert the claims, and merge the claim away without fear of a merger-based suit "for which," under *Parnes*, "there is likely no proper plaintiff on earth."[98]

This is another fundamental incoherence. If a stockholder brings a *Parnes* claim, that stockholder lacks the power to invoke the judicial authority of the State of Delaware unless she can establish at the pleadings stage that the derivative claims were worth more than 1 percent of the value of the merger.[99] Yet when a class of stockholders brings a traditional fiduciary duty suit challenging a large merger and recovers less than that—one half of one percent of the value of a merger, that recovery is ballyhooed as "a very large monetary settlement," "a very substantial achievement for the class," "real money," and a "very good settlement for the class."[100] Go figure.[101]

2. *Parnes* Contorts Traditional Standing Doctrine

The traditional standing analysis concerns whether the plaintiff who comes to the court has the power to seek redress for her grievances.[102] Properly applied, the standing doctrine "answers the question of who has the right to bring an action; it does not inform an analysis of the substantive merits."[103]

When viewed against this backdrop it becomes clear that the *Parnes* test is something else entirely. Its first two elements assess the strength of the underlying derivative claim and the magnitude of the potential recovery;[104] taken together, they crudely approximate the value of the litigation asset. The third element tests the likelihood that another party will or will not litigate the underlying derivative claim after the merger.[105] None of these elements is properly focused, as standing would be, on the relationship between the plaintiff and the claim.

Yet despite its doctrinal misfit, *Parnes* inevitably deprives all stockholders of some Delaware corporations of standing to hold the board of directors to account for alleged breaches of fiduciary duty. Unlike generally applicable standing

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years. *See generally* Bradley R. Aronstam & S. Michael Sirkin, *Post-Closing Litigation Risk in M&A Actions*, INSIGHTS, May 2012, at 9.

98. Golaine v. Edwards, C.A. No. 15404, 1999 WL 1271882, at *7 (Del. Ch. Dec. 21, 1999).

99. *See Massey Energy*, 2011 WL 2176479, at *28.

100. *See* Transcript of Settlement Hearing at 36, 37, 39, 40, *In re* El Paso Corp. S'holder Litig., C.A. No. 6949-CS (Del. Ch. Dec. 3, 2012).

101. This is also suggestive of another inescapable fact: "[T]he reality is that not every deal merits a lawsuit." Transcript of Hearing on Plaintiffs' Counsel's Application for Fees and Expenses and Rulings of the Court at 63, *In re* Zenith Nat'l Ins. Corp. S'holders Litig., C.A. No. 5296-VCL (Del. Ch. July 26, 2010).

102. Dover Historical Soc'y v. City of Dover Planning Comm'n, 838 A.2d 1103, 1110 (Del. 2003); *see also* Whitmore v. Arkansas, 495 U.S. 149, 154 (1990).

103. Gittman-Crowther v. Kent Cnty. Soc'y for Prevention of Cruelty to Animals, C.A. No. 8216-VCN, 2013 WL 3866676, at *2 (Del. Ch. July 25, 2013); *see also* Warth v. Seldin, 422 U.S. 490, 500 (1975) ("[S]tanding in no way depends on the merits of the plaintiff's contention . . . .").

104. *See In re* Primedia, Inc. S'holders Litig., 67 A.3d 455, 477–78 (Del. Ch. 2013).

105. *Id.*

rules, *Parnes* sets up an all-or-nothing standing regime rather than one in which some limited set of stockholders of a corporation has standing. *Parnes* applies across the board to deprive all stockholders of some corporations of standing.

Honest, merits-based, pleadings-stage dismissals are tolerable doctrinally, but the legitimacy of Delaware corporate law is undermined when stockholders lack the *power* to enforce directors' fiduciary duties.[106]

3. *Parnes* Conflicts with the Black-Letter Law of *Tooley*[107]

Like its predecessor *Kramer*, *Parnes* is at bottom a way to distinguish between direct and derivative claims in connection with a merger.[108] In *Tooley*, decided five years after *Parnes*, the Delaware Supreme Court, sitting en banc, gave explicit instructions regarding how to distinguish between direct and derivative claims: "That issue 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)?"[109] Nowhere in *Tooley* did the supreme court mention the three *Parnes* factors.

If *Tooley* were worded differently, certain aspects of the *Parnes* test arguably could be shoehorned into the *Tooley* rubric. But *Tooley* was clear and explicit, and the *Tooley* test is exclusive. The court in *Tooley* also "expressly disapprove[d] . . . the concept of 'special injury,'"[110] a concept that "is not helpful to a proper analytical distinction between direct and derivative actions."[111] The special injury concept eliminated by *Tooley* was applied expressly in *Kramer*[112] and implicitly in *Parnes*, in its reliance upon *Kramer*.[113] Accordingly, the continued viability of *Parnes* has been called into doubt.

4. *Parnes* Conflicts with the Application of the Duty of Loyalty and Entire Fairness Test

First, the *Parnes* test creates a burden-shifting mechanism in a subclass of entire fairness cases. *Primedia* illustrates the point. The challenged merger was a

106. *See, e.g.*, Malone v. Brincat, 722 A.2d 5, 10 (Del. 1998) ("[T]he fiduciary duty of a Delaware director is unremitting.").

107. Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1035 (Del. 2004).

108. *See* Parnes v. Bally Entm't Corp., 722 A.2d 1243, 1245 (Del. 1999) ("In *Kramer v. Western Pacific Industries*, this Court discussed the differences between a derivative claim for mismanagement related to a merger and a direct claim for unfairness in the merger terms." (citing Kramer v. W. Pac. Indus., Inc., 546 A.2d 348, 351–54 (Del. 1988))).

109. *Tooley*, 845 A.2d at 1033. Lest the exclusive aspect of *Tooley* get lost, it was reiterated two pages later. *Id.* at 1035 ("The analysis must be based solely on the following questions: Who suffered the alleged harm—the corporation or the suing stockholder individually—and who would receive the benefit of the recovery or other remedy?").

110. *Id.* at 1039.

111. *Id.* at 1035.

112. *Kramer*, 546 A.2d at 353 ("We do not find such allegations to be sufficient to state a claim of special or direct injury to the common shareholders rather than a derivative claim for waste.").

113. *Parnes*, 722 A.2d at 1245.

"controlling stockholder transaction" in which the "controlling stockholder receive[d] a benefit not shared with the minority."[114] These facts implicated the entire fairness standard, under which "the defendants must establish 'to the *court's* satisfaction that the transaction was the product of both fair dealing *and* fair price.'"[115] The application of entire fairness ordinarily precludes a pleadings-stage dismissal and often requires trial.[116]

Not so in *Primedia*. Despite the application of entire fairness, the plaintiffs had to survive a motion to dismiss where they faced the burden to plead that the derivative claim was viable, that its risk-adjusted net present value was material in the context of the merger, and that the acquiror was unlikely to litigate the claim.[117] Because the *Parnes* test is nominally about standing, it is applied as a threshold determination. Yet when a clear-eyed view reveals the test for what it is—a pragmatic, merits-based assessment of a pleading—its seismic and unwarranted burden-shifting effects come into focus.

Second, in a typical entire fairness case in which a defendant is charged with breaching the duty of loyalty, all ties go to the plaintiff with respect to damages.[118] Here again, *Parnes* undercuts this framework by first requiring the plaintiff to prove that the underlying derivative claim is material in the context of the merger. Rather than giving the plaintiffs the benefit of a "fairer price,"[119] *Parnes* withholds the plaintiff's power to litigate before establishing, at the outset, the ultimate materiality of the expected recovery.[120] This is, therefore, "a rigid

114. *In re* Primedia, Inc. S'holders Litig., 67 A.3d 455, 486 (Del. Ch. 2013). The unshared benefit, of course, was the termination of plaintiffs' standing to continue to litigate derivatively.

115. *Id.* at 488 (quoting Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1163 (Del. 1995)).

116. Orman v. Cullman, 794 A.2d 5, 21 n.36 (Del. Ch. 2002) ("A determination of whether the defendant has met that burden will normally be impossible by examining only the documents the Court is free to consider on a motion to dismiss—the complaint and any documents it incorporates by reference. Besides foreclosing dismissal under Rule 12(b)(6), the requirement of an entire fairness review may also preclude the entry of a final judgment even after discovery on a motion for summary judgment, but only if there remains at that point unresolved questions of material fact on either of the two prongs of the entire fairness test."); *see also id.* ("Although not inevitable in every case, in those cases in which entire fairness is the initial standard, the *likely* end result is that a determination of that issue will require a full trial.").

117. *Primedia*, 67 A.3d at 476–77, 487–88.

118. Thorpe v. CERBCO, Inc., C.A. No. 11713, 1993 WL 443406, at *12 (Del. Ch. Oct. 29, 1993) ("[O]nce a breach of duty is established, uncertainties in awarding damages are generally resolved against the wrongdoer."); *see also* Reis v. Hazelett Strip-Casting Corp., 28 A.3d 442, 466–68 (Del. Ch. 2011).

119. *Reis*, 28 A.3d at 467 ("Depending on the facts and the nature of the loyalty breach," even where a fair price has been shown, stockholders may be entitled to a "'fairer' price.").

120. *See Primedia*, 67 A.3d at 477; *see also In re* First Interstate Bancorp Consol. S'holder Litig., 729 A.2d 851, 861–62 (Del. Ch. 1998) (where plaintiffs alleged that certain pre-merger acts by defendant directors reduced the merger consideration, but did not allege that these acts rendered the merger price unfair, the Court of Chancery held that their claims were derivative and were extinguished by the merger); *but see In re* Ply Gem Indus., Inc. S'holders Litig., C.A. No. 15779, 2001 WL 755133, at *5–6 (Del. Ch. June 26, 2011) (interpreting *Parnes* and *Golaine* as permitting a stockholder to bring direct claims challenging the merger process without necessarily alleging that the resulting merger price was unfair).

rule that permits controllers to impose barely fair transactions,"[121] something that the law otherwise does not permit.[122]

B. The Problems Caused by *Anderson*

Anderson presents a different kind of problem. It appears to create solutions that in practice have not materialized. Instead, the judge-made *Anderson* exceptions conflict with the statutory mechanics of a merger and with standing doctrine.

The surface logic of *Anderson*'s general rule appears inarguable: A plaintiff who ceases to be a stockholder of the corporation as a result of a merger may no longer prosecute derivative claims on behalf of the corporation.[123] This is both a contextual application of the continuous ownership requirement[124] and also a result compelled by section 259 of the DGCL, under which the acquiring corporation in a merger takes ownership of all of the target corporation's rights, privileges, powers, and property.[125] This includes legal claims, control of which "passe[s] by operation of law to [the acquiror], and [the acquiror] alone has the right to determine whether to pursue such claims."[126]

121. *But see Reis*, 28 A.3d at 466 ("The range of fairness permits a court to give some degree of deference to fiduciaries who have acted properly; it is not a rigid rule that permits controllers to impose barely fair transactions.").

122. Guth v. Loft, 5 A.2d 503, 510 (Del. 1939) ("If an officer or director of a corporation, in violation of his duty as such, acquires gain or advantage for himself, the law charges the interest so acquired with a trust for the benefit of the corporation, at its election, while it denies to the betrayer all benefit and profit."); *see also* Gesoff v. IIC Indus., Inc., 902 A.2d 1130, 1154 (Del. Ch. 2006) ("[T]he court can, and has in the past, awarded damages designed to eliminate the possibility of profit flowing to defendants from the breach of the fiduciary relationship.").

123. Lewis v. Anderson, 477 A.2d 1040, 1046 (Del. 1984); *see also* Strategic Asset Mgmt., Inc. v. Nicholson, C.A. No. 20360-NC, 2004 WL 2847875, at *2 (Del. Ch. Nov. 30, 2004) ("Delaware courts adhere to this rule because it is supported by important policy considerations. These considerations include theoretical underpinnings (as derivative actions involve a plaintiff who is enforcing the rights of a separate entity; without ownership it is difficult to explain why a plaintiff has a right to bring a derivative claim) and practical underpinnings (namely, the Court is attempting (a) to insure that the derivative plaintiff is representative of the shareholders and has the incentive to pursue the litigation in the best interest of the shareholders and (b) to prevent 'strike suits')." (footnotes omitted)).

124. *See In re* New Valley Corp. Derivative Litig., C.A. No. 17649-NC, 2004 WL 1700530, at *3 (Del. Ch. June 28, 2004) ("Although section 327 does not explicitly require continuous stock ownership to maintain a derivative action, that requirement has been a staple of Delaware law for over two decades."); *see also* Rosen v. Navarre, C.A. No. 7098, 1985 WL 21155, at *3 (Del. Ch. Oct. 29, 1985) ("In reaching its decision that a plaintiff must remain a stockholder throughout the litigation, the Delaware Supreme Court . . . recently held that 8 *Del. C.* §§ 259, 261 and 327 read individually and collectively mean that a plaintiff who ceases to be a stockholder loses his standing to maintain his stockholder's derivative suit."); Schreiber v. Carney, 447 A.2d 17, 21 (Del. Ch. 1982) ("[A] merger which eliminates a complaining stockholder's ownership of stock in a corporation also ordinarily eliminates his status to bring or maintain a derivative action on behalf of the corporation, whether the merger takes place before or after the suit is brought, on the theory that upon the merger the derivative rights pass to the surviving corporation which then has the sole right or standing to prosecute the action.").

125. Del. Code Ann. tit. 8, § 259 (2011).

126. Kramer v. W. Pac. Indus., Inc., 546 A.2d 348, 355 (Del. 1988); *see also Anderson*, 477 A.2d at 1050 n.19 ("This basic principle of Delaware Corporation Law is explicitly recognized in 8 *Del. C.* § 141(a), Court of Chancery Rule 23.1 and *Zapata Corp. v. Maldonado*, 430 A.2d 779 (1981).").

1. The *Anderson* Exceptions Clash with Section 259

At first glance, the equitable exceptions set forth in *Anderson*'s footnote ten seem sound. It seems inequitable for a fraudulent merger or a paper-shuffling reorganization to disrupt a stockholder's diligent prosecution of meritorious claims.[127] Yet despite their intuitive equitable appeal, the exceptions cannot co-exist with section 259 of the DGCL.

Section 259 governs mergers, including ones that could fit the *Anderson* exceptions. Section 259 also unambiguously provides that the target's legal claims pass to the acquiror in a merger. So, unless there are unwritten exceptions to section 259, a conflict arises between the clear text of section 259 and a judicially created exception to the continuous ownership requirement.

An example illustrates the conflict. Assume that a Delaware corporation fraudulently inflates its financial results, exposing the company to $500 million of securities fraud liability, and exposing the directors to *Caremark* claims for failure to oversee the company's financial reporting. A derivative claim is filed against the directors. In response, they hastily arrange a merger, admittedly for no purpose other than to deprive the derivative plaintiff of standing. Following the merger, the pre-merger derivative plaintiff presses on, claiming equitable standing under the fraud exception. Meanwhile, the acquiror also files suit against the target's former directors, seeking to offset the target's securities fraud liability with a corresponding asset—the *Caremark* claim—that it bought in the deal. The equitable claims of the pre-merger derivative plaintiff collide head-on with the contractual and statutory claims of the acquiror. What results?

The statute trumps.[128] It must. There can be but one recovery from the alleged wrongdoer, and section 259 dictates, indisputably and without exception, that it belongs to the acquiror.[129] To permit the pre-merger plaintiff's equitable claims to trump the acquiror's claims would upset the acquiror's contractual and statutory expectations and would violate the principle that, "as has long been recognized by the Delaware Courts, when the General Assembly has addressed an issue within its authority with clarity, there is no policy gap for the court to fill."[130] Thus, the judge-made *Anderson* exceptions conflict with the statutory and contractual expectations of an acquiror.

127. *See Anderson*, 477 A.2d at 1046 n.10.

128. *See* CML V, LLC v. Bax, 28 A.3d 1037, 1042 (Del. 2011) ("When statutory text is unambiguous, we must apply the plain language without any extraneous contemplation of, or intellectually stimulating musings about, the General Assembly's intent."); *see also* Great Hill Equity Partners IV, L.P. v. SIG Growth Equity Fund I, LLLP, C.A. No. 7906-CS, 2013 WL 6037329, at *2 (Del. Ch. Nov. 15, 2013) ("Whatever the case may be in other states, members of the Delaware judiciary have no authority to invent a judicially-created exception to the plain words [of section 259] and usurp the General Assembly's statutory authority.").

129. *See Great Hill Equity Partners*, 2013 WL 6037329, at *1 ("Most importantly, the Seller's reading is not a plausible interpretation of the plain statutory language [of section 259]. That language uses the broadest possible terms to make sure that 'all' assets of any kind belong to the surviving corporation after a merger.").

130. *Id.* at *3.

2. The *Anderson* Exceptions Conflict with Traditional and Representative Standing Doctrines

Because the acquiror's legal claim to ownership of the target's pre-merger litigation assets trumps the pre-merger stockholders' equitable claim, the *Anderson* exceptions also conflict with traditional standing doctrine. A derivative claim may be brought by a stockholder to remedy harm done to the corporation.[131] Any recovery flows to the corporation, and stockholders benefit only indirectly as its pro rata owners.[132] In a merger, control of the target corporation's claims passes to the acquiror,[133] and the former target stockholders surrender their shares of the target corporation's stock in exchange for the merger consideration.[134]

As a result, a merger inexorably severs the ties that once bound the target corporation's stockholders directly to its litigation assets. The stockholders become strangers to the claims that once belonged to the corporation that once belonged to them. No longer will they share in the corporation's upside, whether that upside is earned by the corporation in business or in litigation. And, as "mere intermeddlers" to a claim now owned by the acquiror, the former target stockholders rightly lack the power—*qua* former target stockholders—to seek redress for the grievances properly belonging to the acquiror.[135]

Moreover, if a *target* stockholder is permitted to litigate derivatively on behalf of the *acquiror*, then the purported representative plaintiff lacks any economic connection to the claim.[136] Not only would a former target stockholder lack standing, but no former target stockholder could be an adequate representative plaintiff.[137] "Delaware decisions on the question of adequacy of a derivative

131. Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984); Taormina v. Taormina Corp., 78 A.2d 473, 475 (Del. Ch. 1951) ("[W]henever a corporation possesses a cause of action which it either refuses to assert or, by reason of circumstances, is unable to assert, equity will permit a stockholder to sue in his own name for the benefit of the corporation . . . .").

132. *In re* Digex Inc. S'holders Litig., 789 A.2d 1176, 1189 (Del. Ch. 2000) ("[W]here the . . . alleged injury . . . falls directly on the corporation as a whole and collectively, but only secondarily, upon its stockholders as a function of and in proportion to their *pro rata* investment in the corporation, the claim is derivative in nature and may be maintained only on behalf of the corporation." (quoting Donald J. Wolfe & Michael A. Pittenger, Corporate and Commercial Practice in the Delaware Court of Chancery § 9-2(a), at 517–18 (1998))).

133. Del. Code Ann. tit. 8, § 259(a) (2011); *see also Kramer*, 546 A.2d at 355 ("Title to such claims has passed by operation of law to [the acquiror], and [the acquiror] alone has the right to determine whether to pursue such claims against the defendants.").

134. Del. Code Ann. tit. 8, §§ 251(b), 253 (2011).

135. Stuart Kingston, Inc. v. Robinson, 596 A.2d 1378, 1382 (Del. 1991).

136. *But see* Parfi Holding AB v. Mirror Image Internet, Inc., 954 A.2d 911, 939 (Del. Ch. 2008) ("The obvious purpose of the continuous ownership rule is to ensure that the plaintiff prosecuting a derivative action has an economic interest aligned with that of the corporation and an incentive to maximize the corporation's value.").

137. *See* South v. Baker, 62 A.3d 1, 21–22 (Del. Ch. 2012) ("A plaintiff seeking to maintain derivative claims must show that she can meet her ongoing fiduciary obligations, including by satisfying the adequacy requirements implicit in Court of Chancery Rule 23.1. The requirement of adequate representation flows from the Due Process Clause of the United States Constitution and the protection it affords the non-parties on whose behalf the representative plaintiff purports to litigate." (citations omitted)).

plaintiff 'are markedly fact-specific,'" but "[r]elevant factors include . . . the existence of economic antagonisms between the plaintiff and those he would represent," and "the relative magnitude of plaintiff's personal interests as compared with his interest in the derivative action itself."[138] To permit a former target stockholder who has become an "empty plaintiff"[139] to litigate the acquiror's claim would not satisfy the adequacy test and would exacerbate the agency costs inherent in derivative litigation.[140]

Moreover, if recovery flows *to the acquiror* under this construct—and by definition it must if the claim is derivative[141]—then the exceptions would do nothing to advance the very equitable purposes for which they were conceived: the protection of *target stockholders* from harm in the event of a fraudulent or paper-shuffling merger.

3. The *Anderson* Exceptions Are Historically and Doctrinally Misunderstood

A plaintiff who seeks to plead a claim under the fraud exception must satisfy the heightened pleading requirements set forth in Court of Chancery Rule 9(b).[142] Beyond that, little can be said for certain about the fraud exception except that its scope is infinitessimal.[143] Precious little can be said for certain about the reorga-

138. *Id.* (quoting DONALD J. WOLFE, JR. & MICHAEL A. PITTENGER, CORPORATE AND COMMERCIAL PRACTICE IN THE DELAWARE COURT OF CHANCERY § 9.02[b][1], at 9-23, 9-31 to 9-32 (2012)) (internal quotation marks omitted).

139. *Parfi Holding*, 954 A.2d at 940 ("Because of the important policy purpose served by the continuous ownership rule, the rule is a bedrock tenet of Delaware law and is adhered to closely. Where, as here, a derivative plaintiff has become an 'empty plaintiff,' the clear policy purpose served by the traditional application of the continuous ownership rule is implicated." (citations omitted)).

140. *Id.* at 940–41 ("Representative actions raise legitimate concerns about the extent of alignment between the interests of the named plaintiffs and of those who the named plaintiffs purport to represent. One can confidently say that adhering to a minimum requirement that the named plaintiffs in a derivative action retain an actual economic interest in the litigation will not be an obstacle to useful derivative suits."); *see* Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 19 (1991) ("The existing regulatory system cannot effectively deal with agency costs that arise in class action and derivative litigation because plaintiffs in the class action and derivative context are often completely incapable of monitoring the attorney."); *see also* Randall S. Thomas & Robert B. Thompson, *A Theory of Representative Shareholder Suits and Its Application to Multijurisdictional Litigation*, 106 NW. U. L. REV. 1753, 1755 (2012) ("In the corporate context, representative litigation includes traditional derivative suits brought by a single shareholder in the name of the entity . . . . In such claims, plaintiffs' lawyers typically have a greater economic stake in the litigation than the individual representative shareholder, so litigation agency costs may ensue.").

141. Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1035 (Del. 2004).

142. Lewis v. Ward, 852 A.2d 896, 905 (Del. 2004).

143. Lewis v. Ward, C.A. No. 15255, 2003 WL 22461894, at *5 (Del. Ch. Oct. 29, 2003), *aff'd*, 852 A.2d 896 (Del. 2004); *see* Kramer v. W. Pac. Indus., Inc., 546 A.2d 348, 354 (Del. 1988) (fraud exception applies only where merger is "perpetrated merely to deprive shareholders of the standing to bring a derivative action"); Globis Partners, L.P. v. Plumtree Software, Inc., C.A. No. 1577-VCP, 2007 WL 4292024, at *8 (Del. Ch. Nov. 30, 2007) (fraud exception applies only where a merger is deemed "pretextual" such that there was "no alternative valid business purpose" other than to extinguish standing); *see also* Brinckerhoff v. Tex. E. Prods. Pipeline Co., 986 A.2d 370, 383 (Del. Ch. 2010) ("The facts here readily support the inference that eliminating the Derivative Action was a principal purpose for the Merger, albeit not the only purpose."); Merritt v. Colonial Foods, Inc., 505 A.2d 757,

nization exception as well. The *Anderson* exceptions thus introduced a cloud of uncertainty. They were recognized nearly three decades ago, but not once since has a Delaware court applied either of them to confer standing in an actual case.

When the *Anderson* court noted "two recognized exceptions to [the] rule of standing as applied to mergers,"[144] it was unclear whether the exceptional cases would be surviving derivative actions or direct actions brought by stockholders on their own behalf. This remains an open question.[145]

The answer may be found in *Anderson* itself, and specifically in its citation to *Bokat v. Getty Oil Co.*[146] for its recognition of the fraud exception.[147] *Bokat* states that the fraud exception applies "in an action making a *direct* attack on the merger" to "protect the innocent *stockholder* victim."[148] This verbiage from *Bokat* suggests that the exceptions are not exceptions at all to the general rule that a merger truncates derivative standing.[149] *Bokat* establishes that the so-called exceptions have been misconceived as exceptions, but are actually descriptions of circumstances in which another species of claim grows out of the underlying derivative claim.

There is more. Not only is the fraud exception not truly an exception, but it also should never have been limited to cases involving common law fraud. When the *Anderson* court noted that this exception applies only if "the merger itself is the subject of a claim of fraud,"[150] it used the term "fraud" in connection with a merger challenge at a time when courts,[151]

763 & n.3 (Del. Ch. 1986) (finding "principal purpose" test satisfied, but holding that fraud exception should be excised completely from the law: "The logic of the derivative form of action compels that result.").

144. Lewis v. Anderson, 477 A.2d 1040, 1046 & n.10 (Del. 1984).

145. *See* Parnes v. Bally Entm't Corp., 722 A.2d 1243, 1245 (Del. 1999) (citing footnote ten of *Anderson* for the proposition that "[a] stockholder who directly attacks the fairness or validity of a merger alleges an injury to the stockholders, not the corporation"); *see also* Ark. Teacher Ret. Sys. v. Caiafa, 996 A.2d 321, 323–24 (Del. 2010) ("If the Vice Chancellor had found that TRS had successfully pleaded its fraud claim, then TRS—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."); *but see* Agostino v. Hicks, 845 A.2d 1110, 1120 (Del. Ch. 2004) ("[I]t may now be the case that an exception to the standing requirement in a derivative action is, in fact, the same thing as a direct action. In my opinion, however, these are intellectually distinct inquiries.").

146. 262 A.2d 246 (Del. 1970).

147. *Anderson*, 477 A.2d at 1046 n.10 (citing *Bokat*, 262 A.2d at 249).

148. *Bokat*, 262 A.2d at 249 (emphasis added).

149. *But see* Feldman v. Cutaia, 951 A.2d 727, 731 (Del. 2008) ("It is now well established that a plaintiff may avoid dismissal of his derivative claims following a merger in only two distinct circumstances: where the claims asserted are direct, rather than derivative, or where one of the exceptions recognized in *Lewis v. Anderson* applies.").

150. *Anderson*, 477 A.2d at 1046 n.10.

151. *See, e.g.*, Cede & Co. v. Technicolor, Inc., 542 A.2d 1182, 1186 (Del. 1988) ("As noted, Cinerama's fraud action charges Technicolor and the other defendants with multiple acts of wrongdoing and breaches of fiduciary duty in the merger, including: waste of assets, self-dealing, intentional and negligent misrepresentation, unfair dealing, accepting a grossly unfair price for Technicolor stock, and carrying out an unlawful merger in violation of Technicolor's certificate of incorporation."); Harman v. Masoneilan Int'l, Inc., 442 A.2d 487, 498 (Del. 1982) (discussing merger-based "'fairness' suits for alleged fraud and breach of fiduciary duty"); Singer v. Magnavox Co., 380 A.2d 969, 972 (Del. 1977) (discussing allegation that "the merger was fraudulent in that it did not serve any busi-

commentators,[152] and authoritative treatises[153] colloquially used the term "fraud" to connote what would be precisely understood today as fiduciary duty-based challenges to merger transactions. The Delaware Supreme Court defined the term "constructive fraud" to include a panoply of equitable causes of action:

> Constructive fraud is a breach of legal or equitable duty which, irrespective of moral guilt, the law declares fraudulent because of its tendency to deceive others, to violate public or private confidence, or to injure public interests. It is a term applied to a great variety of transactions which equity regards as wrongful, to which it attributes the same or similar effects which follow from actual fraud, and for which it gives the same relief as that granted in cases of actual fraud.[154]

These authorities call to mind a bygone era in which the "badge of fraud" rule played much the same role as today's business judgment rule.[155]

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ness purpose other than the forced removal of public minority shareholders from an equity position in Magnavox at a grossly inadequate price"); Muschel v. W. Union Corp., 310 A.2d 904, 908 (Del. Ch. 1973) ("I am of the opinion that the business judgment rule is the standard that must be applied, and that consequently the burden is on Plaintiffs to establish some fraud, or what amounts to fraud, on the part of Western Union in order to prevail at this stage of the proceedings."); *see also* Allied Chem. & Dye Corp. v. Steel & Tube Co. of Am., 120 A. 486, 491 (Del. Ch. 1923) ("Accordingly it has been held that if the majority stockholders so use their power to advantage themselves at the expense of the minority, their conduct in that regard will be denounced as fraudulent and the minority may obtain appropriate relief therefrom upon application to a court of equity."). It is noteworthy that among these written decisions that use the term fraud as a short-hand synonym for merger-based fiduciary duty claims are two authored by the same Delaware Supreme Court Justice who authored *Anderson*. *See generally Technicolor*, 542 A.2d 1182; *Harman*, 442 A.2d 487.

152. *See, e.g.*, Barry F. Schwartz & James G. Wiles, Trans Union: *Neither 'New' Law nor 'Bad' Law*, 10 DEL. J. CORP. L. 429, 438–39 (1985) ("A third party merger . . . had traditionally been tested in Delaware by the so-called 'badge of fraud' rule. . . . Use of the word 'fraud,' with its implication of an intent to deceive, may in particular have led to misunderstanding."); Victor Brudney & Marvin A. Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297, 311 n.37 (1974) (discussing standard of review applied in challenges to the fairness of corporate mergers and equating "bad faith" with "fraud" in context of third-party merger).

153. *See, e.g.*, 1 POMEROY'S EQUITY JURISPRUDENCE § 156, at 179 (3d ed. 1905) ("All instances of constructive trust may be referred to what equity denominates fraud, either actual or constructive, including acts or omissions in violation of fiduciary obligations.").

154. Italo Petroleum Corp. of Am. v. Hannigan, 14 A.2d 401, 407–08 (Del. 1941); *see also* Parfi Holding AB v. Mirror Image Internet, Inc., 794 A.2d 1211, 1236 (Del. Ch. 2001) ("The concept of constructive fraud is an ill-defined one, but generally exists to prevent wrongdoing by someone who occupies a special position of confidence or trust, such as that of a fiduciary. Our corporate case law has thrown this concept around in a not particularly precise way, but always in a context in which the court is examining whether directors have complied with their fiduciary duties." (footnote omitted)); *id.* at 1236–37 ("I read *Bennett* and the other cases as using the words 'constructive fraud' to describe a breach of fiduciary duty, and not as using it as a separate, independent tort. The concept simply captures in more provocative terms the reality that it is a breach of fiduciary duty for directors consciously to transfer corporate assets in exchange for grossly overvalued consideration, particularly when the motivation for the transaction is entrenchment and/or dilution of the minority." (footnote omitted)); *accord* Donald C. Langevoort, *Fraud and Deception by Securities Professionals*, 61 TEX. L. REV. 1247, 1253 (1983) ("For a greater number of courts, however, 'constructive' fraud permits a remedy for any breach of a legal or an equitable duty that has a 'tendency to deceive others, to injure public interests, or to violate public or private confidences. Seizing on the secretive nature of a fiduciary breach and its violation of expectations, many courts simply have concluded that any breach of fiduciary duty is a constructive fraud . . . .").

155. *Compare Allied Chem. & Dye*, 120 A. at 494 ("[I]nadequacy of price will not suffice to condemn the transaction as fraudulent, unless the inadequacy is so gross as to display itself as a badge of fraud."), *with In re* Goldman Sachs Grp., Inc. S'holder Litig., C.A. No. 5215-VCG, 2011 WL 4826104,

No court or commentator has dilated on the impact of what would today be seen as a linguistic anachronism, but this historical oddment suggests that the fraud exception has been mislabeled[156] and misconceived.[157]

It all traces back to *Anderson*. Before *Anderson*, Delaware courts generally held that a merger would dispossess target stockholders of derivative standing, but also recognized the right of target stockholders to challenge the merger directly.[158] Since *Anderson*, the "fraud exception" that once permitted every type of direct challenge to a merger was shrink-wrapped inside the strictures of common law fraud.[159]

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at *16 (Del. Ch. Oct. 12, 2011) ("[W]aste entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade."); *see also Muschel*, 310 A.2d at 908 ("Mere inadequacy of price will not reveal fraud, but rather the disparity must be so gross as to lead the Court to conclude that it was not due to an honest error of judgment, but rather to bad faith, or to reckless indifference to the rights of others interested. Wide discretion in the matter of valuation is confided to directors, and as long as they appear to act in good faith, with honest motives, and for honest ends, the exercise of their discretion will not be interfered with."); Porges v. Vadsco Sales Corp., 32 A.2d 148, 151 (Del. Ch. 1943) ("Complainant's case is simply that the allocation between the old preferred and common stockholders is so unfair that it amounts to fraud. When fraud of this nature is charged, the unfairness must be of such character and must be so clearly demonstrated as to impel the conclusion that it emanates from acts of bad faith, or a reckless indifference to the rights of others interested, rather than from an honest error of judgment.").

156. *See, e.g.*, Lewis v. Ward, 852 A.2d 896, 905 (Del. 2004) (requiring fraud exception claim to be pled with particularity under Rule 9(b)); Globis Partners, L.P. v. Plumtree Software, Inc., C.A. No. 1577-VCP, 2007 WL 4292024, at *8 (Del. Ch. Nov. 30, 2007) (applying sole purpose test); *see also* Brinckerhoff v. Tex. E. Prods. Pipeline Co., 986 A.2d 370, 383 (Del. Ch. 2010) (applying principal purpose test).

157. The analytical basis supporting the exclusivity of appraisal in the short-form merger context suffers the same historical and linguistic fragility. *See* Glassman v. Unocal Exploration Corp., 777 A.2d 242 (Del. 2001) (tracing history of appraisal and entire fairness doctrines and returning to the rule, announced by the Delaware Supreme Court in 1962 in the case of *Stauffer v. Standard Brands, Inc.*, 178 A.2d 311 (Del. 1962), that, absent *fraud*, appraisal is the exclusive remedy for a dissatisfied stockholder in a short-form merger). A fuller exploration of this topic is beyond the scope of this article, but consumers and producers of Delaware law should be aware of the etymological history of the term "fraud" under Delaware law.

158. *See, e.g.*, Braasch v. Goldschmidt, 199 A.2d 760, 762–63 (Del. Ch. 1964) (granting motion to dismiss derivative claims while denying motion to dismiss direct claims challenging controlling stockholder freeze-out: "The complaint alleges numerous acts of mismanagement and seizure of corporate opportunities. It also alleges that the merger . . . resulted from a conspiracy of [the acquiror-controller] and certain of the individual defendants to despoil [the target] and to seize and hold, to the exclusion of the remaining stockholders, the assets of the corporation."); *see also* Ark. Teacher Ret. Sys. v. Countrywide Fin. Corp., 75 A.3d 888, 896 (Del. 2013) ("[T]his Court was careful to cite to that portion of *Braasch* which discusses the survival of *direct* claims . . . and separately to that portion of *Braasch* that discusses loss of derivative standing."); Abelow v. Symonds, 156 A.2d 416, 420 (Del. Ch. 1959) ("However, the simple fact is that plaintiffs purport to seek redress for injuries which they claim are of a personal and primary nature, and while a plaintiff may not characterize an action as non-derivative when in fact it seeks relief for a wrong to his corporation, I am not convinced that plaintiffs should be summarily denied the right to couch their complaint in terms which seek a remedy for alleged personal injury to a class of stockholders as opposed to the theoretical injury to a now dissolved corporate entity."); *accord* Bokat v. Getty Oil Co., 262 A.2d 246, 249 (Del. 1970) (dismissing derivative claims post-merger but recognizing the right to challenge a merger directly: "If a proposed merger is sought to be used for the coverup of wrongful acts of management, a Court of Equity in an action making a direct attack on the merger can and will protect the innocent stockholder victim.").

159. *See Ward*, 852 A.2d at 905 (requiring fraud exception claim to satisfy Rule 9(b)); *see also* Kramer v. W. Pac. Indus., Inc., 546 A.2d 348, 354 (Del. 1988) (fraud exception applies only

Anderson marked a similarly abrupt change in the application of the reorganization exception. Before *Anderson*, Delaware courts addressing the reorganization exception generally focused on the equitable policies underlying the contemporaneous ownership requirement.[160] Since *Anderson*, courts addressing the reorganization exception focus myopically on whether the transaction being challenged is or is not a holdco merger.[161]

Thus, with respect to both of the so-called equitable exceptions that have made it famous, *Anderson* appears to have been historically anomalous and doctrinally out of step.

C. The Problems Caused by Section 327

The application of the contemporaneous ownership requirement to bar post-merger derivative litigation of claims acquired in the merger is inconsistent with the purposes of the rule and with the important policies underlying the derivative suit mechanism.

The contemporaneous ownership requirement applies to "any derivative suit instituted *by a stockholder* of the corporation."[162] It has no application if a corporation sues for itself.[163] Accordingly, section 327 of the DGCL does not foreclose an acquiror from asserting corporate-owned claims acquired by merger, but it does foreclose a stockholder of the acquiror from doing the same thing derivatively. A post-merger acquiror with acquired claims might be the only corporate context in which the board can cause the company to sue but stockholders cannot, even if demand is excused or wrongfully refused. This anomaly is created by the contemporaneous ownership requirement, a rule that generally has been described as "fundamentally incoherent," "ill-suited to each of the purposes advanced to support it," and "unnecessary."[164] Each of those criticisms is magnified by a merger.

As applied to stockholders of the acquiror post-merger, the contemporaneous ownership requirement frustrates the accountability policy underlying de-

where merger is "perpetrated merely to deprive shareholders of the standing to bring a derivative action").

160. *See* Helfand v. Gambee, 136 A.2d 558, 562 (Del. Ch. 1957) ("[P]laintiff was not a direct party to a transaction which made her a stockholder de novo. She purports to sue for the benefit of a business enterprise in which she has held an equitable interest since 1941. The motion to dismiss based on § 327 of Title 8 Del. C. will be denied."); *see also* Schreiber v. Carney, 447 A.2d 17, 22 (Del. Ch. 1982) ("Thus, it is clear that the provisions of 8 *Del. C.* § 327 are not inflexible standards and this Court, as a Court of Equity, must examine carefully the particular circumstances of each case. . . . Plaintiff's position is involuntary insofar as he voted against the merger and his equity interest in the business entity is really still the same. To deny standing, therefore, would not serve to advance the stated purpose of section 327 and would open the door to great abuses.").

161. Bonime v. Biaggini, C.A. Nos. 6925, 6980, 1984 WL 19830, at *3 (Del. Ch. Dec. 7, 1984) (reorganization exception inapplicable where merger involves "two distinct corporations" with "separate boards, officers, assets, and stockholders," and where post-merger entity's "entire corporate mix is distinctly different" from the pre-merger entity in which plaintiff held stock), *aff'd*, 505 A.2d 451 (Del. 1985).

162. Del. Code Ann. tit. 8, § 327 (2011) (emphasis added).

163. *See* Shaev v. Wyly, C.A. No. 15559-NC, 1998 WL 13858, at *4 (Del. Ch. Jan. 6, 1998) ("The contemporaneous ownership requirement of section 327 was not implicated in *Anadarko* because the former subsidiary corporation brought suit on its own behalf; no shareholder sued derivatively.").

164. Laster, *supra* note 20, at 673.

rivative actions generally.[165] The derivative suit's creation as "one of the most interesting and ingenious of accountability mechanisms for large formal organizations"[166] is rooted in the recognition that the stockholders—owners of corporations—stand ready to provide much-needed protection of their corporations from misconduct.[167] The demand requirement developed at common law to strike the appropriate balance between the authority of the board and the stockholders with respect to corporate claims. After a merger, though, that balance is replaced with a new one that affords zero authority to stockholders. Without policy justification, stockholders lose all of their power vis-à-vis the board regarding any acquired claims following an acquisition.

Even absent a merger, the contemporaneous ownership requirement already shrinks the pool of stockholders permitted to litigate corporate claims.[168] To apply the rule by rote in the context of a merger shrinks the pool further still, making it vanishingly small.[169] Section 327 exempts certain claims from the purview of the derivative suit accountability mechanism for the sole reason that they originated with corporations whose ownership has changed hands. But, "[i]f derivative actions promote firm value, even marginally, then a rule that forecloses some number of both meritorious and meritless derivative actions will, all things being equal, transfer some degree of wealth from corporations to the individuals who commit corporate wrongs."[170]

Moreover, applying section 327 to bar post-merger derivative suits by stockholders of the acquiror does not advance the policy purpose of the contemporaneous ownership requirement. Because the derivative action was susceptible to

165. *See, e.g.*, Taormina v. Taormina Corp., 78 A.2d 473, 475 (Del. Ch. 1951) ("[W]henever a corporation possesses a cause of action which it either refuses to assert or, by reason of circumstances, is unable to assert, equity will permit a stockholder to sue in his own name for the benefit of the corporation . . . .").

166. Kramer v. W. Pac. Indus., Inc., 546 A.2d 348, 352 (Del. 1988); *see also* Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984) ("The derivative action developed in equity to enable shareholders to sue in the corporation's name where those in control of the company refused to assert a claim belonging to it.").

167. Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, 95 (1991) ("Devised as a suit in equity, the purpose of the derivative action was to place in the hands of the individual shareholder a means to protect the interests of the corporation from the misfeasance and malfeasance of 'faithless fiduciaries and managers.'" (quoting Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 548 (1949))).

168. This has obvious and pervasive deleterious effects on the level of stockholder monitoring:

> A rule that denies standing to all after-acquiring stockholder-plaintiffs limits the number of stockholders who can effectively monitor and seek to remedy corporate wrongdoing. The result is less protection against corporate wrongdoing than otherwise would exist, and a greater chance that wrongdoing will go undiscovered and unremedied. By arbitrarily fixing and then shrinking the pool of stockholders who can bring derivative claims, section 327 exacerbates the agency costs inherent in the corporate form.

Laster, *supra* note 20, at 691.

169. To be fair, *Lambrecht* plainly left open the courthouse door to stockholders who hold shares of the target as of the time of the original wrongdoing and who, by virtue of a stock-for-stock merger, become stockholders of the acquiror. But this rule would unduly fetishize the form of merger consideration, and would signal to acquirors that if they pay cash as opposed to stock in a merger, no one will have post-merger derivative standing.

170. Laster, *supra* note 20, at 691 & n.89.

misuse by opportunistic stockholders and their lawyers,[171] the Delaware General Assembly adopted what became section 327.[172] But a stockholder of the acquiror has no more committed the "evil of a purchased lawsuit" than a stockholder of an independent corporation that suffers an actionable harm giving rise to a derivative claim. There is no act of intent or volition in either case, nor any attempt to search for one.[173] Accordingly, applying the contemporaneous ownership requirement to bar a derivative suit by a stockholder of the acquiror who held shares when the merger was announced and continuously thereafter does nothing to advance the policies behind the requirement.

III. Proposal

These identified problems can all be solved by a revamped regime consisting of three simple rules. In short, *Parnes* should be overruled, the concept of the *Anderson* exceptions should be eliminated, and stockholders of an acquiring corporation should be deemed contemporaneous owners for purposes of asserting derivative claims acquired by merger. Not only would the proposed system solve all of the identified problems plaguing the current one, but it would be more stable, more predictable, and even more black-letter.

A. The First Rule: Without Exception, a Target Stockholder Who Is Not Paid Fair Value for Her Shares, Including Value Attributable to the Corporation's Derivative Claims, Should Have Standing to Challenge the Merger Directly

This rule is designed to cure the ills caused by the *Parnes* test. It would remove the fundamental incoherence, close the escape hatch, and restore the proper

171. *See, e.g.*, Schoon v. Smith, 953 A.2d 196, 203 (Del. 2008) ("Over time, the stockholder derivative action became stigmatized as a 'refuge of strike suit artists specializing in corporate extortion.'" (quoting Carol B. Swanson, *Juggling Shareholder Rights and Strike Suits in Derivative Litigation: The ALI Drops the Ball*, 77 Minn. L. Rev. 1339, 1348 (1993))); *see also Schoon*, 953 A.2d at 203 ("As explained by former Chancellor Collins J. Seitz, this provision and its predecessor were enacted solely 'to prevent what has been considered an evil, namely, the purchasing of shares in order to maintain a derivative action designed to attack a transaction which occurred prior to the purchase of the stock.'" (quoting Rosenthal v. Burry Biscuit Corp., 60 A.2d 106, 111 (Del. Ch. 1948))). This backstory of the contemporaneous ownership requirement is confirmed by the Folk Report, which is the closest thing to legislative history that exists with respect to the DGCL. *See* MCI Telecommc'ns Corp. v. Wanzer, C.A. Nos. 89C-MR-216, 89C-SE-26, 1990 WL 91100, at *10 (Del. Ch. June 19, 1990) ("The Folk Report is a contemporaneous analysis of proposed amendments to the Delaware indemnification statute and is helpful legislative history."). In his report, Professor Folk described the function of section 327 as "precluding the evil of purchased rights to bring derivative actions." Ernest L. Folk, III, Review of the Delaware Corporation Law 98 (1967).

172. Del. Code Ann. tit. 8, § 327 (2011) ("In any derivative suit instituted by a stockholder of a corporation, it shall be averred in the complaint that the plaintiff was a stockholder of the corporation at the time of the transaction of which such stockholder complains or that such stockholder's stock thereafter devolved upon such stockholder by operation of law.").

173. *See* Desimone v. Barrows, 924 A.2d 908, 927 (Del. Ch. 2007) ("Section 327 is clear that stock ownership at the time of challenged conduct is a prerequisite to maintaining a derivative action and the General Assembly has not legislated a 'state of mind exception' to that requirement.").

function of corporate litigation to merger-based suits involving companies possessing litigation assets. It would also restore the pre-*Anderson* regime in which a merger could be challenged directly by stockholders for "constructive fraud" or any of its variants, including breach of fiduciary duty.[174] And it could be implemented promptly by a Delaware court.

Critically, the proposed rule would grant target stockholders standing to assert merger-based breach of fiduciary duty claims against target directors. The underlying derivative claim need not be litigated and resolved in this merger-based class action proceeding, except to the extent that it is relevant to the court's resolution of the merger-based fiduciary duty claims against the target directors for agreeing to and/or recommending an unfair merger.[175] "[T]he Court does not look upon the graceless creature of a suit within a suit with warm approval," but it is the inevitable result of the collision between corporate and stockholder-owned actions "[a]t the singularity of the effective time"[176] of a merger.[177]

First, this rule would remove the incoherence caused by *Parnes* and would treat a derivative claim like any other asset of the corporation.[178] All target stockholders would have standing to challenge a merger directly if a merger is not in their best interests, whether because they are not being fairly compensated for their share of a derivative claim or for their share of any other corporate asset. There is no *Parnes*-like test to establish standing if a stockholder challenges a merger because it undervalued a division of the corporation's business, a piece

174. *See supra* Part II.B.3.

175. *See* Nagy v. Bistricer, 770 A.2d 43, 62 (Del. Ch. 2000); *see also* Del. Code Ann. tit. 8, § 251(b) (2011) ("The board of directors of each corporation which desires to merge or consolidate shall adopt a resolution approving an agreement of merger or consolidation and declaring its advisability."); Frontier Oil v. Holly Corp., C.A. No. 20502, 2005 WL 1039027, at *28 (Del. Ch. Apr. 29, 2005) ("[I]t was the duty of the Holly Board to review the transaction to confirm that a favorable recommendation would continue to be consistent with its fiduciary duties."); Strassburger v. Earley, 752 A.2d 557, 579 (Del. Ch. 2000) ("[W]here a merger is found to have been effected at an unfairly low price, the shareholders are normally entitled to out-of-pocket (i.e., compensatory) money damages equal to the 'fair' or 'intrinsic' value of their stock at the time of the merger, less the price per share that they actually received . . . ."); *In re* Radiology Assocs., Inc. Litig., C.A. No. 9001, 1990 WL 67839, at *13 (Del. Ch. May 16, 1990) ("[U]nder our current law, . . . this evaluation could take place in connection with an entire fairness or appraisal action.").

176. Brinckerhoff v. Tex. E. Prods. Pipeline Co., 986 A.2d 370, 383 (Del. Ch. 2010).

177. Merritt v. Colonial Foods, Inc., 505 A.2d 757, 766 (Del. Ch. 1986). Moreover, because derivative claims are assets of the corporation that must be valued in an appraisal proceeding, the Court of Chancery has already begrudgingly accepted the reality of the nested derivative suit. Bomarko, Inc. v. Int'l Telecharge, Inc., C.A. No. 13052, 1994 WL 198726, at *3 (Del. Ch. May 16, 1994) ("[B]reach of fiduciary duty claims that do not arise from the merger are corporate assets that may be included in the determination of fair value . . . ."); Porter v. Tex. Commerce Bancshares, Inc., C.A. No. 9114, 1989 WL 120358, at *5 (Del. Ch. Oct. 12, 1989) ("A merger in which a corporation's shareholders received stock in another corporation, other securities or cash, will always result in termination of the right of the pre-merger shareholders to sue on behalf of the company. . . . If the company has substantial and valuable derivative claims, they, like any asset of the company, may be valued in an appraisal."); *see also Nagy*, 770 A.2d at 55–56 (similar); Gonsalves v. Straight Arrow Publishers, Inc., C.A. No. 8474, 1996 WL 483093, at *1 n.1 (Del. Ch. Aug. 22, 1996) (noting complexity of applying net settlement value of corporation-owned claims as assets of the corporation in appraisal action).

178. *See supra* Part II.A.

of real property, or a control premium, for example. It makes just as little sense as applied to litigation assets.[179]

Consider what would happen if a company with pending derivative claims announced a merger today. The dutiful derivative plaintiff would dismiss the derivative action to challenge a merger directly under *Parnes*. But if another M&A plaintiff filed a cookie-cutter complaint advancing unspecified challenges to the merger without making mention of the derivative claim, that plaintiff would have standing to sue while the derivative plaintiff could be left out in the cold. Pleading a merger case involving underlying derivative claims is easier for plaintiffs that know nothing about the corporation than it is for the plaintiff that has been pursuing its rights derivatively. This makes little sense.

Second, this rule would shut and deadbolt the escape hatch that exists under *Parnes*.[180] No longer would a stockholder be required to establish the materiality of her claim to establish standing. As a result, corporate managers would expect to be held accountable to stockholders for even "immaterial" violations of fiduciary duty, which can be worth hundreds of millions of dollars to stockholders depending on the size of the corporation.[181] And, the sell-side fiduciaries negotiating a merger will have every incentive to understand and maximize the value of the company's litigation assets, just as with any other corporate assets. By eliminating the opportunity for abuse, this rule would also eliminate the disincentive for stockholders to monitor their elected fiduciaries. This rule would therefore deter corporate wrongdoing directly, and would also encourage both sell-side directors and stockholders generally to become more effective monitors of malfeasance that threatens the well-being of Delaware corporations.

Third, this rule would restore order to the application of the entire fairness standard and the duty of loyalty in merger cases involving litigation assets.[182] Without the misnomer of standing now affixed to the elements of the *Parnes* test, they would no longer have burden-shifting effects.[183] Likewise, without

179. This is not to say that a plaintiff could state a claim simply by cherry-picking an asset and claiming it was undervalued in a merger. A complaint of that sort would not survive a motion to dismiss under either the business judgment rule or *Revlon*'s enhanced scrutiny, which "at bottom . . . is a test of reasonableness; directors are generally free to select the path to value maximization, so long as they choose a reasonable route to get there." *In re* Dollar Thrifty S'holder Litig., 14 A.3d 573, 595–96 (Del. Ch. 2010). For example, if a board was shopping a corporation with pending derivative claims and it informed prospective bidders about the claims and encouraged bidders to investigate and assess them, then the board arguably has satisfied its fiduciary obligations under *Revlon* on the theory that the market value of the litigation asset was captured by the auction. *See, e.g.*, Applebaum v. Avaya, Inc., 812 A.2d 880, 889–90 (Del. 2002) ("While market price is not employed in all valuation contexts, our jurisprudence recognizes that in many circumstances a property interest is best valued by the amount a buyer will pay for it."). This result should hold regardless of whether or not the winning bidder ultimately litigates the claims, provided that the merger agreement did not prohibit the acquiror from doing so.

180. *See supra* Part II.A.1.

181. Just because corporate managers could expect to face litigation does not mean that they should be held liable for judgments. This article advocates removing a misconceived barrier to stockholder standing so that complaints may be tested—and time and again dismissed—according to the claims alleged and the transactionally appropriate standard of review.

182. *See supra* Part II.A.4.

183. *See supra* Part II.A.4.

the *Parnes* requirement that a stockholder plaintiff establish materiality, plaintiffs asserting claims that rightfully implicate the duty of loyalty would get the benefit of the doubt regarding damages that ordinarily applies to duty of loyalty cases.[184]

But to say that the standing test established by *Parnes* would be overruled does not mean that its constituent parts would be discarded. Courts would continue examining these three factors, but would do so candidly, in frank acknowledgement that they are evaluating the strength of the plaintiff's pleading on its merits.

As then-Vice Chancellor Leo E. Strine has observed, the so-called standing test required by *Parnes* is in fact a threshold merits determination cloaked under the guise of standing[185]:

> That is, *Parnes* can be straightforwardly read as stating the following basic proposition: a target company stockholder cannot state a claim for breach of fiduciary duty in the merger context unless he adequately pleads that the merger terms were tainted by unfair dealing. If the plaintiff cannot meet that pleading standard, then he has simply not stated a claim under Rule 12(b)(6).[186]

Apart from the facetiousness of its "standing" label, the *Parnes* test is a "quite sensible basis for determining which, if any claims, ought to survive a merger."[187]

This is a typically keen observation from a trial court judge who, when faced with binding state supreme court precedent, has to play the ball as it lies.[188] *Parnes* does provide a sensible way to determine whether a plaintiff has stated a viable claim, but the law would be clearer and more forthright if it did not cloak this determination within the quasi-jurisdictional doctrine of standing.[189]

184. *See supra* Part II.A.4.

185. Golaine v. Edwards, C.A. No. 15404, 1999 WL 1271882, at *7 (Del. Ch. Dec. 21, 1999) ("[T]he derivative-individual distinction as articulated in *Parnes* is revealed as primarily a way of judging whether a plaintiff has stated a claim on the merits. In this sense, the distinction seems to be a quite sensible basis for determining which, if any claims, ought to survive a merger."); *In re* Gaylord Container Corp. S'holders Litig., 747 A.2d 71, 82 (Del. Ch. 1999) ("In a merger extinguishing plaintiffs' status as stockholders, the question of whether the plaintiffs' claims are individual or derivative becomes outcome determinative. If the claims are individual, the plaintiffs' claims survive the merger. If not, the plaintiffs' claims are extinguished."); *id*. ("The confluence of *Parnes* and *Kramer* will in reality indirectly create such a 'bitter with the sweet' method, but in the non-merits context of an evaluation of whether the plaintiff's complaint challenges the overall fairness of the deal and therefore states an individual claim. An appropriate application of ordinary business judgment rule and entire fairness principles should be adequate to eliminate such windfalls, which in the post-squeeze out transaction context do not involve stockholders who purchased their shares to buy into litigable claims.").

186. *Golaine*, 1999 WL 1271882, at *7.

187. *Id*.

188. *See* Ash v. McCall, C.A. No. 17132, 2000 WL 1370341, at *13 n.47 (Del. Ch. Sept. 15, 2000) ("[I]f this area of Delaware law is to be made consistent with basic economic principles, as well as fundamental principles of equity and fairness, it will have to come from the Delaware Supreme Court.").

189. *Gaylord*, 747 A.2d at 82 ("Undoubtedly, there is a need to prevent windfalls to plaintiffs who have accepted the benefits of a corporate transaction extinguishing their ownership of stock and who continue thereafter to challenge the transaction. The question is whether the test for distinguishing between individual and derivative claims really is the best way to do that. Other possibilities would seem more direct.").

The three component parts of the *Parnes* test should be repurposed as part of a holistic, merits-based analysis. This way, the Court of Chancery may conduct openly and honestly the same pragmatic analysis that *Parnes* compels it to do under the thinly veiled guise of standing. "This might be a more direct, and less erratic, method to achieve the desirable and necessary end . . . ."[190]

Taking the third *Parnes* factor first, the likelihood that an acquiror would litigate the target corporation's derivative claims can dictate the standard of review that applies to a merger challenge.[191] As a result, this factor's importance to the merits of the case cannot be overstated.

Primedia is a perfect example of this.[192] In *Primedia*, Vice Chancellor Laster found that the acquiror was unlikely to assert the company's claim post-closing against Primedia's controlling stockholder.[193] As a result, entire fairness applied to the merger challenge because the merger offered only to the controller the opportunity to terminate a claim against it, a benefit unshared with the minority stockholders.[194] Absent the derivative claim, a challenge to the merger would have been evaluated under the "enhanced scrutiny" standard of review and

190. *Id.*

191. The Delaware courts have identified several reasons other than the best interests of the corporation to suspect that an acquiror might not pursue meritorious post-merger claims in a given case, including perceived conflicts of interest or other social issues between the directors of the acquiror and the target:

> Human dynamics enter the picture. The acquiring company has just purchased the target company in a process run by the same directors and officers who the acquiring corporation would be suing. Would the deal have happened if the directors and officers thought they would face a suit from the buyer? For companies who regularly make acquisitions, a reputation for pursuing claims against sell-side fiduciaries would not help their business model. Moreover, directors of the acquired corporation may join the combined entity's board, and senior officers of the acquired company may become part of the ongoing management team. Those individuals would become defendants in the acquirer's lawsuit.

Carsanaro v. Bloodhound Techs., Inc., 65 A.3d 618, 664 (Del. Ch. 2013); *see also In re* Primedia, Inc. S'holders Litig., 67 A.3d 455, 476 (Del. Ch. 2013) ("It was even more unlikely that a financial buyer like TPG would sue a fellow private equity firm like KKR."); Harold Marsh, Jr., *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35, 55 (1966) ("In the case of a purchase of a controlling block of stock by a new controller, if the effect of the transactions of the former management with the corporation have been fully disclosed in the financial statements on the basis of which the purchase was made, it seems like dirty pool for the new controller to bring an action against his vendors in the name of the corporation. . . . [T]he chances of an action being brought by the corporation itself in this situation are slim."). These suspicions about "human dynamics" would be substantially allayed by a rule permitting acquiror stockholders to sue derivatively on the acquiror's behalf should it be unwilling or unable to pursue valuable claims post-merger. *See infra* Part III.C. And, in private equity buyouts in which there are no acquiror stockholders, the target board can mitigate these suspicions by shopping the corporation, including a fulsome exposition of its litigation assets, to a wide range of strategic and financial bidders on a level playing field. Presumably, the resulting sale to the highest bidder will capture the market value, if any, of the derivative claims, and would thereby negate the inference that the buyer could not be expected to litigate the claims. *See Primedia*, 67 A.3d at 483 ("Without such allegations and the resulting inferences, the merger consideration logically would incorporate value for the litigation, and the merger would not have harmed the sell-side stockholders.").

192. *See Primedia*, 67 A.3d at 486–88.

193. *Id.*

194. *Id.*

would have fared well.[195] But, because of one critical fact—that the acquiror was unlikely to litigate the target's derivative claim post-merger—the entire fairness standard applied, a result that can be outcome determinative in its own right.[196]

Primedia thus underscores the need for the proposed reconfiguration of the law. A garden-variety *Revlon* case ripe for dismissal can morph into an entire fairness case headed for trial because, under existing law, a merger offers a way for directors and controllers to potentially escape liability. If the law were reconfigured as proposed herein, then directors and controllers would not perceive any liability-diminishing benefit to a merger, and they would make merger decisions according to the best interests of the corporation and its stockholders. There would be no benefit unshared with the minority,[197] and no reason for weak *Revlon* cases to become more muscular entire fairness ones.

As for the remaining two parts of the *Parnes* test—the viability of the underlying derivative claim and the relative magnitude of any potential recovery—they both comprise core issues in a merger-based class action of this type. Together, they approximate the expected value of the claim and, correspondingly, the company's litigation asset. The apparent strength of the derivative claim also affects both the standard of review[198] and a potential damages award.[199] And of course,

195. Enhanced scrutiny "places the burden on the defendant fiduciaries who approved the final stage transaction to show that they acted reasonably to obtain for their beneficiaries the best value reasonably available under the circumstances." Reis v. Hazelett Strip-Casting Corp., 28 A.3d 442, 459 (Del. Ch. 2011). In *Primedia*, "[i]t [was] undisputed for purposes of this litigation that the Merger Board worked to obtain the best value reasonably available for Primedia's business." 67 A.3d at 474.

196. AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. Ch. 1986) ("Because the effect of the proper invocation of the business judgment rule is so powerful and the standard of entire fairness so exacting, the determination of the appropriate standard of judicial review frequently is determinative of the outcome of derivative litigation."); *but see* Nixon v. Blackwell, 626 A.2d 1366, 1376 (Del. 1993) ("Application of the entire fairness rule does not, however, always implicate liability of the conflicted corporate decisionmaker, nor does it necessarily render the decision void."). If entire fairness applies, then the defendants must establish "to the court's satisfaction that the transaction was the product of both fair dealing and fair price." Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1163 (Del. 1995) (internal quotation marks omitted).

197. This is because the proposed rules would incentivize directors and controllers to openly market and obtain value for the corporation's litigation assets as part of the sale process. *See supra* notes 179 & 191.

198. This is, in many ways, the converse of the likelihood that the acquiror will litigate the claims. If the claims are perceived as strong, then a court is more likely to find that a self-interested desire to terminate them led to the merger decision, as opposed to an unadulterated consideration on the proverbial clear day of whether a merger would be in the stockholders' best interests. Where a transaction process is tainted by self-interested behavior, however slight, the court applies more searching forms of review. *See Reis*, 28 A.3d at 457–59 ("The human psyche has a powerful ability 'to rationalize as right that which is merely personally beneficial.'" (quoting City Capital Assocs. Ltd. P'ship v. Interco Inc., 551 A.2d 787, 796 (Del. Ch. 1988))); *see also* eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 20 (Del. Ch. 2010) ("Human judgment can be clouded by subtle influences like the prestige and perquisites of board membership, personal relationships with management, or animosity towards a bidder.").

199. Because the stockholders are entitled to their pro rata share of the risk-adjusted net present value of the derivative claims, *see Primedia*, 67 A.3d at 483–84, an apparently stronger pre-merger derivative claim represents a potentially greater eventual damages award.

the value of the derivative claim relative to the merger corresponds directly to the damages potentially recoverable in the merger action.

One downside to the proposed extension of standing is that despite its doctrinal improvements, the elimination of the materiality requirement under *Parnes* could encourage nickel-and-dime suits that could threaten to impede large corporate mergers. The *Parnes* test is a rough-justice balancing effort to stop weak claims in their tracks and allow strong ones to proceed. The proposed rule would open the door to more derivative claim-based merger litigation and would ensnare litigants in a procedural morass. Target stockholders could find themselves suing target directors to challenge a merger for failure to achieve value for derivative claims at the same time that the acquiror is suing the same target directors, litigating the same underlying derivative claims on the merits. The court could coordinate the actions, but complex litigation is expensive and procedural questions remain.

Doctrinal concerns aside, there is no pragmatic reason to give stockholder plaintiffs and their lawyers another tool to hold up deals and extract a toll by the threat of a preliminary injunction. Nonetheless, the perceived problem would be ameliorated by the Court of Chancery's recognition that suits of this type—M&A actions based on underlying derivative claims—should be money damages cases rather than injunctive relief cases.[200] Accordingly, they can proceed on a normal, post-closing litigation track and should not impair a deal's progress toward closing.[201]

And, this would have been of much greater concern nearly fifteen years ago when *Parnes* was decided than it is today because the prevalence of merger litigation has been on a meteoric rise. In 2007, less than 40 percent of public company mergers and acquisitions became the subject of litigation.[202] By 2012, that number is well north of 90 percent.[203] Given the ubiquity of stockholder litigation challenging mergers today, it seems unfathomable that a merger that would eliminate viable derivative claims would escape the prying eyes of the M&A plaintiffs' bar. Accordingly, the marginal effect of eliminating the *Parnes* barrier to entry would be negligible. It would not create more suits, but would focus pleadings-stage motion practice on the transactionally appropriate standard of review and its application instead of pseudo-standing principles.

200. To state a claim of this type, a plaintiff would typically have to plead a non-exculpated breach of the duty of loyalty based upon the board's failure to achieve value for the derivative claim. The sole harm, if any, to stockholders in such a case is that they received inadequate merger consideration by not being compensated for their share of the corporation's litigation asset. This forecloses, in most cases, a pre-closing injunction. *See In re* Delphi Fin. Grp. S'holder Litig., C.A. No. 7144-VCG, 2012 WL 729232, at *18 (Del. Ch. Mar. 6, 2012) ("A harm that can be remedied by money damages is not irreparable.").

201. *See generally Primedia*, 67 A.3d 455 (post-closing litigation); *see also In re* Massey Energy Co. Derivative & Class Action Litig., C.A. No. 5430-VCS, 2011 WL 2176479, at *29 (Del. Ch. May 31, 2011) (noting the availability of post-closing damages as one reason to deny preliminary injunction).

202. Parsons & Tyler, *supra* note 83, at 477.

203. In 2012, stockholders challenged approximately 93 percent of all deals above $100 million and 96 percent of all deals above $500 million. *See* Robert M. Daines & Olga Koumrian, Shareholder Litigation Involving Mergers and Acquisitions 2 (2013).

Fiduciary litigation is an imperfect enforcement mechanism at best.[204] But perfect can always be the enemy of good, and, in this context, the risks of under-deterrence outweigh the risks of over-deterrence.[205] Unlike the D&O crisis of the mid-1980s or the general principles underlying the *Caremark* standard or the business judgment rule, this is not a context in which the law needs to protect directors to encourage socially optimal risk-taking. Rather, this is a realm of stockholder litigation that has a noticeable enforcement gap.

Recognizing that stockholders have standing to challenge mergers in this way does not imply that these claims should routinely skate past a motion to dismiss. Quite the contrary. Many of these claims will be markedly weak.[206] But stock-

204. *Massey Energy*, 2011 WL 2176479, at *29 ("We do not live in a perfect world and the ability of human institutions to do full justice will always fall short of the ideal."). *Massey* presents a difficult case under any set of rules because the target stockholders arguably benefitted as owners of a corporation that for years achieved higher profits at the expense of others by shirking its regulatory and safety responsibilities. *Id.* ("Moreover, any purchaser of Massey would recognize that a primary challenge will be to instill a new culture in the company that better fosters safety and a constructive relationship with the company's regulators, with the goal of generating profits in a durably sustainable manner. This may well involve the expenditure of greater resources on safety and other near-term investments."). Under the rules proposed in this article, these unsympathetic plaintiffs would nonetheless have standing to litigate their merger-based claim, but the path to recovery would remain long, and the claim itself would remain dubious for several valid reasons other than standing. *See id.* at *28 ("If another market player really believed that Alpha was paying too low a price because it was possible to purchase Massey for more because a purchaser could obtain a collectible judgment against former Massey fiduciaries for over $1 billion in the Derivative Claims, that player has had, and continues to have, a rational opportunity to buy Massey for itself. . . . Information does not seem like a genuine barrier in this circumstance."); *see also id.* at *27 ("Assuming, therefore, that Massey is determined to be liable to miners and their families for violating the criminal law, and if the outcome of those proceedings suggests that top level Massey fiduciaries were responsible, it is not clear why Alpha would not seek to offset the costs to itself of those violations by suing previous management if by doing so it had a realistic chance of obtaining some meaningful recovery."). Nonetheless, *Massey* demonstrates the procedural and equitable difficulty that the Delaware courts would face in certain circumstances of trying to address both the merger-based claims of the former target stockholders and the underlying *Caremark*-based derivative claims now belonging to the acquiror post-merger. Under the proposed regime, the target stockholders could proceed with their merger-based claim promptly after closing and, if successful in establishing liability under the transactionally appropriate standard of review, could recover the risk-adjusted expected value of the litigation asset as of the merger date. The acquiror's *Caremark* claims, in the nature of indemnification for corporate losses, still must await the ultimate determination of the corporation's out-of-pocket losses. If the primary claims against the corporation resulted in $1 billion of liability, the acquiror could then seek $1 billion in indemnification against the directors in the form of the *Caremark* claim, irrespective of the outcome of the merger litigation. The procedural difficulty of a case like this would be real, but it would not be insurmountable, and the Court of Chancery would be up to the task, for the sake of all of the improvements the proposed rules would make in Delaware law.

205. *See* Subin v. Goldsmith, 224 F.2d 753, 767 (2d Cir. 1955) (Frank, J., dissenting) ("An economy like ours, which thrives on the fact that thousands of persons of modest means invest in corporate shares, will be poorly served if our courts regard with suspicion all minority stockholders' suits, and, therefore, out of a desire to discourage such suits, apply to them unusually strict pleading rules, thus tending to thwart judicial inquiries into the conduct of wrongdoing, controlling stockholders. The unfortunate consequence will be that those in control may be immunized from effective attacks on their misdeeds, and, as a result, the small investors will lose confidence in all corporate managements, the honest as well as the dishonest.").

206. *See, e.g.*, Miramar Firefighters Pension Fund v. AboveNet, Inc., C.A. No. 7376-VCN, 2013 WL 4033905, at *4 (Del. Ch. July 31, 2013) (dismissing *Revlon* claim based on inadequate consideration); *In re* Morton's Rest. Grp., Inc. S'holders Litig., 74 A.3d 656, 676 (Del. Ch. 2013) ("When a board of disinterested directors uses two qualified investment banks and reaches out to

holders who are owed unremitting fiduciary duties under corporate fiduciary law are also owed the power to assert their grievances in court, even if they end in pleadings-stage dismissals. "An appropriate application of ordinary business judgment rule and entire fairness principles should be adequate" to sort the claims that should succeed from those that should not.[207]

All target stockholders should have standing to sue target directors directly to challenge a merger that does not compensate target stockholders for the loss of derivative claims. This rule would take away from the board the nuclear option of eliminating derivative liability by merger. It would also allow courts to stop hiding behind, and trampling on, the doctrine of standing; instead, courts could candidly evaluate merger-based challenges on their merits according to the transactionally appropriate standard of review. Most critically, this rule would restore to all stockholders the ability, at any time, to hold their elected fiduciaries accountable for merger-related misconduct.[208]

B. The Second Rule: Without Exception, a Merger Should Extinguish a Target Stockholder's Derivative Standing

This rule would eliminate the statutory conflict and doctrinal confusion caused by the de jure existence of the *Anderson* exceptions.[209] Nothing is known for certain about the nature of a case that survives under the *Anderson* exceptions.[210] If they are direct claims as the history of the doctrine suggests, then the exceptions are superfluous of the proposed rule that all target stockholders have standing to challenge a merger that unfairly disposes of derivative claims.[211] There would be no equitable gaps to fill. All stockholders would have recourse by which to obtain fair value for that which has been taken from them. But if the exceptions are truly exceptions, in that the surviving cases are derivative claims, then doctrinal conflicts abound.

First, post-merger derivative litigation by a former target stockholder would run head-on into section 259 of the DGCL. Section 259 provides that ownership

over 100 potential buyers in an extended effort to induce competition and get the best price, it is not conceivable that they will be acting in bad faith simply because the bankers' valuation models do not accord with a plaintiff's birthday dreams of enormous value."). The counterexample would be a case like *Primedia*, where the board ran a process and hired a financial advisor, but neither the sale process nor the financial advisor ever considered the value of the litigation asset. *See Primedia*, 67 A.3d at 474–75, 484. In that scenario, a plaintiff could state a non-exculpated claim that "the Board acted in bad faith by relying on what it knew was an inaccurate analysis." *See In re* Celera Corp. S'holder Litig., C.A. No. 6304-VCP, 2012 WL 1020471, at *25 (Del. Ch. Mar. 23, 2012), *aff'd in part, rev'd in part*, 59 A.3d 418 (Del. 2012).

207. *In re* Gaylord Container Corp. S'holders Litig., 747 A.2d 71, 82 (Del. Ch. 1999); *see also* Onti, Inc. v. Integra Bank, 751 A.2d 904, 931–32 (Del. Ch. 1999) (concluding, after trial and application of entire fairness, that derivative claims had risk-adjusted net present value of zero).

208. This simple rule could be adopted by any Delaware court in recognition of the argument that *Parnes* was overruled by *Tooley* in 2004 and is no longer a permissible way to fulfill its stated purpose of distinguishing between direct and derivative claims. *See supra* Part II.A.3.

209. *See supra* Part II.B.1.

210. *See supra* Part II.B.3.

211. *See supra* Part III.A.

of a corporation's legal claims passes to the surviving or resulting corporation in a merger.[212] It has no exceptions. "When statutory text is unambiguous," Delaware courts honor it.[213] Accordingly, section 259 trumps any judicially created exception to the rules of derivative standing. And because the claim belongs to the acquiror post-merger, no former target stockholder could serve as an adequate representative plaintiff.[214]

Second, with the target corporation merged out of existence, there is no vehicle through which the target stockholder could conceivably litigate "derivatively." Inventive minds could conjure up an undead corporate body—a litigation trust-like vehicle that would exist solely as a pass-through entity to facilitate derivative litigation by former target stockholders—but to what end?

The pragmatic and equitable solution is simply a direct action.[215] But if the stockholders are permitted to proceed directly on a class-wide basis, then their claims are not truly "exceptions to th[e] rule of [derivative] standing as applied to mergers,"[216] as denominated by *Anderson*, but rather merger-based fiduciary duty challenges.[217] Eliminating the exception language and permitting stockholders to challenge mergers directly in these circumstances would take away the uncertainty that will linger around the exceptions until they are clarified and applied to an actual case, or else removed entirely.

A merger should eliminate the derivative standing of target stockholders, period.[218] This proposal would remove the *Anderson* exceptions and the confusion

212. *See* DEL. CODE ANN. tit. 8, § 259 (2011).

213. CML V, LLC v. Bax, 28 A.3d 1037, 1042 (Del. 2011) ("We disagree. When statutory text is unambiguous, we must apply the plain language without any extraneous contemplation of, or intellectually stimulating musings about, the General Assembly's intent.").

214. *See* South v. Baker, 62 A.3d 1, 21–22 (Del. Ch. 2012) ("A plaintiff seeking to maintain derivative claims must show that she can meet her ongoing fiduciary obligations, including by satisfying the adequacy requirements implicit in Court of Chancery Rule 23.1. The requirement of adequate representation flows from the Due Process Clause of the United States Constitution and the protection it affords the non-parties on whose behalf the representative plaintiff purports to litigate." (citations omitted)); Parfi Holding AB v. Mirror Image Internet, Inc., 954 A.2d 911, 940 (Del. Ch. 2008) ("Because of the important policy purpose served by the continuous ownership rule, the rule is a bedrock tenet of Delaware law and is adhered to closely. Where, as here, a derivative plaintiff has become an 'empty plaintiff,' the clear policy purpose served by the traditional application of the continuous ownership rule is implicated." (citations omitted)).

215. Brinckerhoff v. Tex. E. Prods. Pipeline Co., 986 A.2d 370, 383 (Del. Ch. 2010) ("[A]s a result of [a] Merger, the distinctions between a derivative action on behalf of [the corporation] for the indirect benefit of its [stockholders] and a class action on behalf of those same [stockholders] have blurred. . . . In light of the dual nature of the claim, I would see no reason why the plaintiffs could not . . . continue[] their action post-Merger as a *de facto* class action on behalf of [the target corporation's stockholders] as of the effective time.").

216. Lewis v. Anderson, 477 A.2d 1040, 1046 (Del. 1984).

217. *See supra* Part II.B.3. Claims belonging to the target stockholders must be merger-based because ownership of the underlying corporate claims passed to the acquiror in the merger.

218. It bears mentioning that *Anderson*'s fateful footnote ten contained "two recognized exceptions" that the *Anderson* court deemed inapplicable to the case before it. Lewis v. Anderson, 477 A.2d 1040, 1046 n.10 (Del. 1984). Accordingly, the footnote consisted fully of "statements . . . that [were] unnecessary to the resolution of the case before the court." *In re* MFW S'holders Litig., C.A. No. 6566-CS, 2013 WL 2436341, at *3 (Del. Ch. May 29, 2013). It is therefore dictum and should be treated accordingly; that is, without any precedential value. *See id.* at *17 ("In Delaware, such dictum is without precedential effect." (citation omitted)); *see also* Gatz Props., LLC v. Auriga

they create, as well as their conflict with the statutory mechanics of a merger under the DGCL. And, if the law recognized that stockholders have standing to challenge mergers directly for failure to provide value for derivative claims as proposed herein, then the exceptions become superfluous. Eliminating the specter of the equitable exceptions would capitalize on the recognized benefit of the continuous ownership requirement.[219]

C. The Third Rule: Without Exception, All Stockholders of the Acquiror as of the Time of a Merger Announcement Should Be Deemed Contemporaneous Owners of Claims Acquired from the Target in the Merger[220]

This rule would restore the full panoply of remedies to stockholders of corporations that happen to acquire claims, and would prevent the unprincipled misapplication of the continuous ownership requirement.

After a merger, it is no less "important for shareholders to bring derivative suits . . . as an *ex post* check on corporate behavior."[221] Likewise, stockholders of an acquiror post-merger are no less deserving of "protection . . . from the designing schemes and wiles of insiders who are willing to betray their company's interests."[222] There is similarly no principled reason that those stockholders should endure without "the chief regulator of corporate management" and with "little practical check on . . . abuses" at the hands of "faithless directors and managers."[223]

And, if stockholders of the acquiror could proceed derivatively following a merger, then they would police potential conflicts of interest that often cause those in control of corporations to elect not to pursue claims. "Human dynamics

Capital Corp., 59 A.3d 1206, 1218 (Del. 2012) ("For the reasons next discussed, that court's statutory pronouncements must be regarded as dictum without any precedential value."); Crown EMAK Partners, LLC v. Kurz, 992 A.2d 377, 398 (Del. 2010) ("Therefore, the Court of Chancery's interpretation of stock ledger in section 219 is *obiter dictum* and without precedential effect."); *In re* Opinion of the Justices, 57 Del. 264, 270 (1964) ("It is a well-settled rule of law that statements amounting to mere *obiter dicta* do not become binding precedents and fall outside the rule of *stare decisis*.").

219. *See* Strategic Asset Mgmt., Inc. v. Nicholson, C.A. No. 20360-NC, 2004 WL 2847875, at *2 (Del. Ch. Nov. 30, 2004) ("One of the benefits of the 'continuous ownership requirement' is that it is straightforward.").

220. Importantly, this rule is designed to change only the determination of the legal fact of contemporaneous ownership, and not standing more generally. The distinction becomes important between the announcement of a merger and its closing. During this time, the claim is still owned by the target corporation, so stockholders of the acquiror would not have standing because they would be empty plaintiffs. Parfi Holding AB v. Mirror Image Internet, Inc., 954 A.2d 911, 940 (Del. Ch. 2010). But, for purposes of a subsequent, post-closing derivative claim brought on behalf of the acquiror, a stockholder would be deemed a contemporaneous owner only if he or she held stock of the acquiror as of the announcement. In other words, contemporaneous ownership of the acquiror would be determined as of the announcement date, but standing more fundamentally would still await closing, which is when corporate ownership and control of the claim changes hands under section 259. *See* Del. Code Ann. tit. 8, § 259 (2011). As a result, the proposed rule remains faithful to both the legislative purpose of section 327 and the fundamental principles of derivative standing that require an economic interest in the claim.

221. Seinfeld v. Coker, 847 A.2d 330, 333 (Del. Ch. 2000).

222. Surowitz v. Hilton Hotels Corp., 383 U.S. 363, 371 (1966).

223. Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 548 (1949).

enter the picture,"[224] and if they do in a way that subjugates the interests of the corporation, then the availability of stockholder action provides a cleansing mechanism. And, because the demand requirement already weeds out cases except where a majority of the board would be conflicted,[225] this cleansing mechanism would come into play where it is needed most—in conflict situations where the agency costs are exacerbated.

Moreover, "while [section 327 of the DGCL] should be construed so as to reasonably effectuate its primary purpose—to discourage a type of strike suit—it should not be construed so as to unduly encourage the camouflaging of transactions and thus prevent reasonable opportunities to rectify corporate aberrations."[226] But that is exactly what it does when it prevents stockholders of an acquiror, who have taken no voluntary act in recognition of potential litigation, from litigating claims acquired by the corporation in a merger.

Accordingly, the contemporaneous ownership requirement should be rewritten or reinterpreted to permit stockholders to proceed derivatively so long as they were stockholders of the corporation as of the time the claim inured to their indirect benefit. This modest change remains faithful to the stated purpose of the contemporaneous ownership requirement in the non-merger context, and provides greater transparency and accountability to the resolution of derivative actions affected by merger.

A statutory amendment may in fact be unnecessary to achieve the desired result. The proposed rule finds ample support in *Lambrecht v. O'Neal*,[227] in which the Delaware Supreme Court described a double-derivative suit as follows:

> A post-merger double derivative action is not a *de facto* continuation of the pre-merger derivative action. It is a new, distinct action in which standing to sue double derivatively rests on a different temporal and factual basis—namely, the failure of the [acquiror's] board, post-merger, to enforce the premerger claim of its wholly-owned subsidiary.[228]

On its face, this conception of a post-merger double derivative claim is more expansive than the literal application of section 327 would have predicted. The core holding of *Lambrecht* is that a plaintiff who was a stockholder of the target corporation at all relevant times through a stock-for-stock merger has post-merger double-derivative standing, as a continuous stockholder of the acquiror,

224. Carsanaro v. Bloodhound Techs., Inc., 65 A.3d 618, 664 (Del. Ch. 2013).

225. *See, e.g.*, Kaplan v. Peat, Marwick, Mitchell & Co., 540 A.2d 726, 730 (Del. 1988) ("The right to bring a derivative action does not come into existence until the plaintiff shareholder has made a demand on the corporation to institute such an action or until the shareholder has demonstrated that demand would be futile."); *see also* Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984) (setting forth two steps of a demand futility analysis: whether (1) "the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment").

226. Maclary v. Pleasant Hills, Inc., 109 A.2d 830, 833 (Del. Ch. 1954).

227. 3 A.3d 277 (Del. 2010).

228. *Lambrecht*, 3 A.3d at 290; *see also id.* at 290 n.44 ("To be sure, the pre-merger original derivative action and the post-merger double derivative action do share one element in common: the underlying merits claim. But that is all.").

to proceed derivatively.[229] Under a narrow reading of *Lambrecht*, the plaintiff's ownership of the target's stock as of the time of the underlying wrongdoing is critical under the contemporaneous ownership requirement.

But if the post-merger double-derivative action is "a new, distinct action in which standing to sue double derivatively rests on a different temporal and factual basis,"[230] and the "temporal and factual basis" upon which standing depends relates to the acquiror's failure or refusal to assert claims post-merger, then the "transaction of which such stockholder complains"[231] is the merger itself, in which the acquiror took control of claims it then failed to assert. Accordingly, under *Lambrecht*, no amendment to section 327 would be necessary because post-merger claims of the acquiror accrue, for purposes of the contemporaneous ownership requirement, as of the date of the merger.[232]

Candidly, this may be a solution in search of a problem. Under *Lambrecht*, stockholders of the acquiror have recourse if the directors elect not to vindicate the corporation's claim: They could sue their directors for breach of fiduciary duty for failing to liquidate a valuable and expiring corporate asset. Moreover, there are not many commonly recurring factual scenarios in which the stockholders of an acquiror would satisfy the demand futility test. One transactional paradigm that comes to mind is where the target and the acquiror share a common controller. If a minority stockholder of the target asserts claims derivatively against the common controller and then loses standing in the merger, a minority stockholder of the acquiror could conceivably pick up the baton post-merger and satisfy the demand futility test. If only section 327 of the DGCL did not get in the way.

There are ample reasons why the derivative suit was created and no reason why it should be denied to stockholders of the acquiror as of the time of the merger. Even if its use would be rare, there is no equitable reason that stockholders who can surpass the demand requirement should not have the power to litigate derivatively. Faithfully following the policy principles underlying the contemporaneous ownership requirement, all stockholders of the acquiror should have standing to pursue all of the acquiror's legal claims so long as the stockholder owned shares as of the time at which the corporation took control of the claims, whether by the claim's accrual, by merger, or otherwise. Accordingly, all stockholders of the acquiror as of the time of a merger announcement should be deemed contemporaneous owners for purposes of post-merger derivative standing.

Conclusion

The existing law in this area is a maze of rules and exceptions that are overly complex, ill-suited to their purposes, and in tension with each other and with

229. *See generally id.*

230. *Id.* at 290.

231. Del. Code Ann. tit. 8, § 327 (2011).

232. The proposed rule would not affect the limitations period applicable by analogy under the doctrine of laches to derivative claims transferred in a merger.

other important principles of Delaware law and public policy. The law would be clearer and its application more forthright if the three standing rules set forth in this article were followed.

The proposed system of rules would protect the stockholders of Delaware corporations from the potential misconduct that could seep into the interstitial space between derivative actions and merger transactions. No longer would a merger give corporate managers a way out; they would have to pay fair value for the claims in a settlement or a merger, or else be forced to litigate the claims on their merits.

The overriding purpose of this article is to help make the law work better. It is not designed to favor plaintiffs or defendants, but rather to favor Delaware, a state whose corporate law is one of its chief exports. Doctrinal consistency is the goal. Until that goal is achieved in this context, the compensatory and deterrence purposes of fiduciary litigation will be compromised, and the doctrinal clarity of Delaware law—one of its hallmarks—will risk avoidable erosion.