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Delaware Court of Chancery Dismisses Breach of Fiduciary Duty Claims Because Merger Resulted in Loss of Standing

In *In re Massey Energy Company Derivative and Class Action Litigation*, the Delaware Court of Chancery recently dismissed shareholders' derivative and putative direct claims alleging that Massey's former directors and officers caused the company to willfully disregard safety regulations. Despite finding that shareholders had stated a "viable" claim that the directors had breached their duty of oversight under *In re Caremark International, Inc. Derivative Litigation* – claims that are difficult to plead successfully – the court found that they nevertheless lacked standing because they no longer held shares of the corporation due to an intervening merger.

Background

In April 2010, an explosion occurred at a coal mine owned by Massey Energy Company killing 29 workers, making it the worst mining disaster in the United States in 40 years. Government and private investigations concluded that the event was a direct result of Massey's systematic and willful violations of safety regulations. The disaster led to the criminal conviction of several Massey executives, including its former Chairman and CEO. Shortly thereafter, following a sale process, Massey entered into a merger agreement to be acquired by Alpha Natural Resources, Inc.

Plaintiffs, Massey shareholders, sought a preliminary injunction against the proposed merger, which the Court of Chancery denied. Thereafter, shareholders approved the merger, which closed in June 2011. For the next five years, the action was stayed due to ongoing criminal investigations and Alpha's bankruptcy filing in 2015. When Alpha emerged from bankruptcy, the court considered the defendants' motion to dismiss plaintiffs' claims under the then-operative complaint, which did not directly challenge the merger, but instead were styled as both direct and derivative fiduciary duty claims against former Massey officers and directors.

Analysis

In granting the defendants' motion to dismiss, the Court of Chancery made the following key findings:

- *Although plaintiffs stated a "viable derivative claim for relief under* Caremark," *the court dismissed their derivative claim due to lack of standing*. It is well-settled Delaware law that, subject to two limited exceptions, under the so-called "continuous ownership rule," shareholders of Delaware corporations must hold shares not only at the time of the alleged wrong, but continuously thereafter throughout the litigation in order to have standing to maintain derivative claims, and will lose standing when their status as shareholders is terminated as a result of the merger. Here, the plaintiffs lost their shares as a result of the Massey-Alpha merger, and therefore lost standing to bring their derivative claim. Although the court acknowledged that plaintiffs otherwise stated a viable *Caremark* claim (i.e., that the directors failed to meet their duty of oversight and acted in bad faith by failing to establish or oversee a monitoring system for the corporation's compliance with the law) despite that such claims are "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment," plaintiffs' derivative claim must nonetheless be dismissed for lack of standing.

- *Plaintiffs' putative "inseparable fraud" claim, which they attempted to style as a direct claim, was actually a derivative claim subject to the continuous ownership rule and also failed for lack of standing.* Plaintiffs' putative direct claim was based on an acknowledgement from previous Delaware Supreme Court decisions that Delaware law "recognizes a single, inseparable fraud when directors cover massive wrongdoing with an otherwise permissible merger." To state a claim of inseparable fraud, a plaintiff must plead facts from which it would be reasonably conceivable that (1) a defendant engaged in serious misconduct before a merger that constitutes a direct claim and (2) the merger must have been "necessitated" or made "inevitable" by that misconduct. As the court emphasizes, under this theory, the challenged conduct preceding a merger must itself form the basis of a direct claim and does not constitute an exception to the continuous ownership rule for derivative standing. Here, the court concluded that plaintiffs failed to state a claim of inseparable fraud, and that their claim was in reality derivative as it was the corporation that both suffered the alleged harm and would receive the benefit of any recovery, not the shareholder individually. Citing *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, the court stated that "actions charging mismanagement which depress the value of stock allege a wrong to the corporation; i.e., . . . a derivative action." Noting that plaintiffs' challenge to the pre-merger conduct "boils down to a theory of mismanagement" and not one involving conduct—fraudulent or otherwise—that caused injury to any stockholder individually or separately from causing harm to the corporation, the court dismissed the claim for lack of standing under the continuous ownership rule.

- *The shareholder vote on the merger between Alpha and Massey did not operate to cleanse the conduct giving rise to plaintiffs' claims under* Corwin *v.* KKR Financial Holdings, LLC. The court noted that the policy underlying *Corwin* was never intended to serve as a "massive eraser" to exonerate corporate fiduciaries for all wrongdoing preceding a shareholder-approved transaction. *Corwin* does not dictate that a fully informed shareholder vote will "cleanse" director conduct where, as here, plaintiffs' claims do not challenge the merits of the transaction itself, but instead challenge conduct that occurred well before the transaction and that does not have a proximate relationship to the shareholder-approved transaction.

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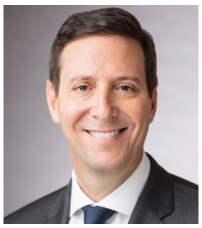

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