DOUBLE-DERIVATIVE SHAREHOLDER ACTIONS IN THE WAKE OF STOCK-FOR-STOCK MERGERS

Shareholder derivative actions can emerge as an important issue for nearly everyone involved in a company’s activities, including its executives, board members, in-house attorneys, principals and other shareholders. Under certain circumstances, this mechanism can allow a shareholder to redress harm to the corporation by bringing a lawsuit on the corporation’s behalf where the corporation’s management is prevented from doing so due to conflicts of interest.

As such, the derivative action can be an important corporate governance device to protect shareholders from corporate waste and wrongdoing. In the hands of opportunistic plaintiffs’ lawyers, however, the device can also be a costly drain on corporate resources and a source of management distraction. Also, bear in mind that many of the rules that have been developed around derivative actions are applicable to companies ranging from the largest public corporations to closely held LLCs and partnerships.

The Delaware Supreme Court, a leading authority on corporate law, has recently spoken definitively on an issue that will be of particular interest to those involved in corporate acquisitions. Specifically, in Lambrecht v. O’Neal, the court has addressed the question of whether and under what circumstances a pre-merger shareholder of an acquired company, who has become a current shareholder of the acquiring company by virtue of a stock-for-stock merger, may bring a derivative action based on conduct that took place at the acquired company before the merger.

CASE BACKGROUND

This case arose from derivative claims brought in a New York federal court by former shareholders of Merrill Lynch who alleged that Merrill’s senior management and board members breached fiduciary duties in connection with the company’s involvement in underwriting collateralized debt obligations, risky mortgage-related activities, and improper payment of bonuses. When Merrill was subsequently acquired by Bank of America in a stock-for-stock merger, these derivative claims were extinguished based on the rule requiring a derivative plaintiff to maintain stock ownership both at the time of the alleged wrongdoing and throughout the course of the litigation.

The purpose of the continuous ownership requirement is to ensure that derivative plaintiffs have a true interest in the corporation’s affairs. The Delaware Supreme Court’s recent pronouncement makes it particularly important that those involved with acquisitions of troubled or distressed companies bear in mind any potential derivative litigation by shareholders of the acquired company in assessing and planning for the costs and possible gains of post-merger litigation, in negotiating indemnity provisions, and in determining the optimal structure and consideration for acquisitions.

THE BOTTOM LINE

Corporate management, in-house counsel, and stockholders should be aware of potential shareholder derivative litigation in approaching corporate transactions. The Delaware Supreme Court’s recent pronouncement makes it particularly important that those involved with acquisitions of troubled or distressed companies bear in mind any potential derivative litigation by shareholders of the acquired company in assessing and planning for the costs and possible gains of post-merger litigation, in negotiating indemnity provisions, and in determining the optimal structure and consideration for acquisitions.

>> continues on next page
stake in redressing alleged harm to the company and to prevent the buying and selling of derivative claims through the sale of stock. The court, however, left open the possibility that the plaintiff shareholders could re-file the action as a “double-derivative” action in their capacities as new Bank of America shareholders, which they did. A “double-derivative” action is the means through which a shareholder of a parent corporation can seek recovery for harm to a subsidiary.

The defendants argued that the plaintiffs’ double-derivative suit as Bank of America shareholders should be dismissed because they still could not meet the continuous ownership requirement. Although plaintiffs now could meet the requirement of holding stock at the time of the litigation, defendants contended that plaintiffs must also demonstrate that, at the time of the alleged wrongdoing at the acquired company,

- plaintiffs owned stock in the acquiring company, and
- the acquiring company owned stock in the acquired company.

The defendants’ argument was based in part on prior precedent that could be read to support these requirements. Faced with the important Delaware law question of whether plaintiffs in fact were required to meet these additional requirements, the federal court in New York certified this question of law to the Delaware Supreme Court, which agreed to address the issue.

**RULING**

The Delaware Supreme Court rejected the defendants’ contention that plaintiffs would have to show their ownership in the acquiring corporation and the acquiring corporation’s ownership of the subsidiary at the time of the wrongdoing, and overruled prior caselaw to the extent it held otherwise. The court took a practical approach to the issue, noting that double-derivative actions are an important mechanism for corporate governance and that the defendants’ proposed criteria “would effectively eviscerate the double derivative action as a meaningful remedy.” One of the cornerstones of the court’s reasoning was its finding that, assuming the plaintiffs could satisfy the legal requirements to bring a derivative suit on behalf of Bank of America, the lawsuit on behalf of Bank of America against the Merrill officers and directors was not truly a derivative action and thus did not have to meet the continuous share ownership requirement. Rather, the court reasoned that Bank of America could enforce its rights directly in its capacity as 100% owner of Merrill.

**CONCLUSION**

Through its holding, *Lambrecht* effectively breathed life into the double-derivative remedy, particularly in the wake of stock-for-stock mergers. This development may be particularly significant with regard to the acquisitions of troubled or distressed companies where there are allegations of mismanagement or wrongdoing by the acquired companies’ officers and directors. *Lambrecht* makes clear that derivative actions by the acquired company’s former shareholders based on these allegations will not, as a practical matter, be extinguished by the merger so long as those shareholders receive stock of the acquiring company as part of the acquisition.

**FOR MORE INFORMATION**

James R. Levine
Partner
212.468.4985
jlevine@dglaw.com

or the D&G attorney with whom you have regular contact.