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Delaware Supreme Court Clarifies Law Regarding Standing Of Plaintiff-Shareholders To Bring A Post-Merger Double Derivative Action

In *Lambrecht v. O'Neal*, No. 135, 2010, 2010 WL 3397451 (Del. Aug. 27, 2010), the Supreme Court of Delaware answered a certified question of Delaware law from the United States District Court for the Southern District of New York regarding the standing of a plaintiff-shareholder of a parent corporation to bring a "double derivative" action following a merger. The Court held that plaintiffs who were pre-merger shareholders in an acquired company and who, by virtue of a stock-for-stock merger, are current shareholders of a post-merger parent company need *not* demonstrate for purposes of standing that, at the time of the alleged wrongdoing at the acquired company, (1) they owned stock in the acquiring company, and (2) the acquiring company owned stock in the acquired company. In so holding, the Court clarified the law allowing for the possibility of double derivative claims where standard derivative claims are extinguished by an intervening merger.

The certified question of law arose out of two double derivative actions asserted on behalf of Bank of America ("BofA") and its wholly-owned subsidiary, Merrill Lynch & Co. ("Merrill Lynch"). Originally, plaintiffs in those actions filed standard derivative actions on behalf of Merrill Lynch to recover losses Merrill Lynch suffered in transactions that occurred before BofA acquired Merrill Lynch in the wake of the 2008 financial crisis in a stock-for-stock merger. Plaintiffs alleged that Merrill Lynch's senior management and directors breached their fiduciary duties by involving Merrill Lynch in underwriting collateralized debt obligations and by disregarding warnings about risks concerning its mortgage-related activities, thereby causing Merrill Lynch to lose billions of dollars. In addition, plaintiffs also alleged that on the eve of the merger, Merrill Lynch, with the assent of BofA, improperly paid bonuses totaling $3.6 billion to various Merrill Lynch employees.

In the merger, Merrill Lynch became a wholly-owned subsidiary of BofA, and plaintiffs' Merrill Lynch shares were converted to shares of BofA. After the merger, the complaints were amended to take the form of "double derivative" actions in which the plaintiffs sought the same relief. A "double derivative" action is a suit brought by a shareholder of a parent corporation on behalf of the parent to enforce a claim belonging to a subsidiary that is either wholly owned or majority controlled by the parent.

Defendants then moved to dismiss the double derivative actions for lack of standing. Defendants argued that plaintiffs were required to show that (1) plaintiffs were BofA stockholders both post-merger and at the time of the pre-merger wrongdoing complained of, and (2) BofA was a Merrill Lynch stockholder at the time of such pre-merger conduct. The Supreme Court assumed, for purposes of its analysis, that at least one plaintiff's ownership of BofA stock was not contemporaneous with the conduct complained of, and that BofA was not a Merrill Lynch stockholder during the time of the wrongdoing alleged by plaintiffs.

In determining whether the procedural requirements proposed by defendants were mandated under Delaware law, the Delaware Supreme Court first examined defendants' conceptual model, whereby a double derivative action represents "two separate derivative lawsuits, one stacked on top of the other," consisting of both a standard derivative action by BofA (through plaintiffs), asserting a claim on Merrill Lynch's behalf, and a "superimposed" action asserting the same claim derivatively on BofA's behalf as the new owner. Under such a model, the Court noted, the procedural requirements for bringing each derivative claim would independently need to be satisfied.

The Court then noted four flaws in defendants' proposed conceptual model. First, it explained that the procedural requirements posed by defendants would render double derivative lawsuits "virtually impossible to bring except in bizarrely happenstance circumstances" where, for example, plaintiff-shareholders of the acquired corporation at the time of the pre-merger wrongdoing also simultaneously (and coincidentally) held stock of the acquiring corporation at the time of the pre-merger wrongdoing complained of *and* the acquiring corporation held stock of the acquired corporation at the time of the pre-merger wrongdoing. Thus, because "the defendants' argued-for double derivative model . . . would effectively eviscerate the double derivative action as a meaningful remedy," the Court found that rejection of the defendants' position was warranted even "on that basis alone."

Second, the Court held that defendants' argument that BofA must have owned Merrill Lynch stock at the time of the pre-merger wrongdoing incorrectly presupposes that to be legally capable of enforcing Merrill Lunch's pre-merger claim, BofA must proceed *derivatively* against the persons who were Merrill Lynch directors at the time of the alleged wrongdoing. The Court held that defendants misinterpreted Delaware case law, which holds that BofA may enforce such a claim *directly*, by virtue of its 100 percent ownership interest in Merrill Lynch. Indeed, BofA's sole ownership of Merrill Lynch "empowers and entitles" the company to "use its *direct* control to cause its wholly owned subsidiary, Merrill Lynch, to do what is necessary to enforce Merrill Lynch's pre-merger claim" (emphasis added).

Third, the Supreme Court also held as "fatally flawed" defendants' assertion that plaintiffs must have owned BofA stock at the time of the alleged misconduct at Merrill Lynch. The Court explained held that this notion misapplied the contemporaneous ownership requirement in double derivative actions. It explained that in double derivative actions, "the plaintiffs stand in the shoes of [the acquiring company]; that is, they are enforcing [the acquiring company's] post-merger right, as 100 percent owner, to prosecute [the acquired company's] pre-merger claim." Thus, it suffices that the plaintiffs "own shares of [the acquiring company] at the time they seek to proceed double derivatively on its behalf."

Finally, in response to the defendants' policy argument that "allowing the plaintiffs' post-merger double derivative action to proceed would "disrespect the corporate separateness of [BofA] and Merrill Lynch" and run afoul of Delaware precedent on the impact of a merger on a pending derivative action, the Court determined that a double derivative action is not a *de facto* continuation of a pre-merger derivative action, but instead represents a "new, distinct action" in which the plaintiffs' standing to sue rests upon "a different temporal and factual basis," namely, a failure by the BofA board, post-merger, to prosecute plaintiffs' pre-merger claim against Merrill Lynch. Furthermore, because of this "quite different structure, the policies favoring both the preservation of the corporate separateness of the parent and subsidiary and the prevention of abusive derivative suits are fully respected."

Finally, the Supreme Court rejected defendants' argument that the Delaware Court of Chancery's 2004 decision in *Saito v. McCall*, 2004 WL 3029876 (Del. Ch. Dec. 20, 2004) ("*Saito*"), provided legal support for defendants' proposed procedural requirements, finding that *Saito* addressed the requirements for a double derivative claim in a "conclusory" fashion as a result of the procedural posture of the case. The Court explicitly overruled *Saito* as a "misappli[cation] [of] Delaware law," noting that no reasoning is articulated to support *Saito*'s holding. Furthermore, the Supreme Court also concluded that to the extent *Saito* is inconsistent with the Supreme Court's reasoning and conclusions in the instant case, it is overruled.

This decision demonstrates the Delaware Supreme Court's emphasis that state precedents not only validate, but also encourage, 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. *See*, *e.g.*, *Lewis v. Ward*, 852 A. 2d 896, 906 (Del. 2004). More importantly, prior to this decision, the main case that had touched on the requirements for bringing double derivative actions following a merger was the Chancery Court's decision in *Saito*, which the Supreme Court held did so in a "conclusory" manner and which was not representative of "sound Delaware law." Thus, this decision provides the clear guidance on when a plaintiff-shareholder may bring a post-merger double derivative action.

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