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Delaware Court of Chancery Upholds Continuous Ownership Rule in Dismissing Derivative Claims of Mismanagement

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In re Massey Energy Co. Deriv. & Class Action Litig., C.A. No. 5430-CB (Del. Ch. May 4, 2017), Bouchard, C.

The Delaware Court of Chancery granted the defendants' motion to dismiss the complaint based on the continuous ownership rule. Despite the plaintiffs' characterization of their claims as direct, the Court found that allegations of mismanagement were derivative in nature, and a subsequent merger stripped the plaintiff stockholders of standing to pursue claims on behalf of the acquired company.

Nominal Defendant Massey Energy Company (the "Company") was one of the largest producers of coal in the United States. It was managed by its board of directors, specifically CEO and Chairman of the Board Don L. Blankenship who valued production above workplace safety. In April 2010, there was a fatal explosion at the Company's Upper Big Branch coal mine in West Virginia. Studies determined that the Company's failure to adhere to safety precautions contributed to the explosion.

Several weeks after the explosion, Alpha Appalachia Holdings, Inc. ("Alpha") approached Blankenship about a potential acquisition of the Company. The Company's board rejected the proposal, but Alpha would not be deterred and made several additional offers to purchase the Company. The Company established a strategic alternatives review committee to consider future opportunities. At the quarterly meeting, Blankenship proposed a five-year, stand-alone plan. The strategic alternatives review committee considered Blankenship's plan as well as solicited bids from third parties. The Company's board ultimately accepted Alpha's offer and unanimously approved the merger.

Two pension funds and two individuals who purportedly were stockholders of the Company commenced a derivative action against various officers and directors of the Company, with the plaintiffs alleging that the defendants showed systematic and willful disregard for safety regulations. Count I of the complaint asserted a direct claim for inseparable fraud, while Count II of the complaint put forth a derivative claim of mismanagement under *Caremark.* The defendants moved to dismiss the complaint.

The continuous ownership rule requires "stockholders of Delaware corporations [to] 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." A stockholder will lose standing to file suit when his or her status as a stockholder is terminated as a result of a merger unless the merger is the subject of a claim of fraud or the merger is a reorganization that does not affect the plaintiff's ownership in the company. In this instance, the merger stripped the plaintiffs of their capacity to sue, and they did not allege facts that would give rise to either exception, nor did they argue in their opposition to the motion that the exception applies. Accordingly, the Court found that the plaintiffs did not possess legal standing to pursue the *Caremark* claim and dismissed Count II of the complaint.

The plaintiffs' remaining claim met a similar fate based on the Court's finding that the plaintiffs failed to set forth a claim for inseparable fraud. Inseparable fraud is not a third exception to the continuous ownership rule; rather, it is a direct claim which requires proof "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." Whether a claim is direct or derivative depends on who suffered the harm and who will receive the benefit of any recovery. In this action, the plaintiffs alleged that management employed "a deliberate and systematic business plan" to disregard workplace safety prior to the merger that exposed the Company to financial harm. Despite the plaintiffs' characterization of the fraud as a direct claim, the Court found that the allegations amounted to mismanagement, in which "Delaware courts have long recognized that actions charging mismanagement which depress the value of stock allege a wrong to the corporation." Where no individual stockholder suffered an injury separate from the Company that was capable of surviving dismissal following the merger, the claim failed.