Can a take-over protect directors and officers from personal liability resulting from pending shareholder derivative actions?

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On April 5, 2010, 29 Massey Energy employees were killed in the Upper Big Branch coal mine disaster in West Virginia.[1] Accusations of negligence and criminal wrongdoing led to federal and state regulatory scrutiny, wrongful death tort claims on behalf of the victims, and derivative shareholder suits against directors and officers.[2] In reaction to this disaster and its fallout, Massey’s stock price plummeted and Alpha Natural Resources opportunistically offered to take...
over the beleaguered company. [3] Shareholders, concerned that the merger would stop their
derivative action suits for lack of standing under Delaware General Corporation Law §259(a),
sued for injunctive relief in the Delaware Court of Chancery to block the merger [4]

Derivative actions are lawsuits by shareholders against directors and officers on behalf of the
corporation to recoup losses caused by the breach of fiduciary duties of the directors and
officers. [5] Successful suits make the directors and officers personally liable to the corporation
for their actions. [6] As was the case for Massey directors and officers, such liability is usually
covered by directors and officers insurance. [7]

The Delaware Court of Chancery ruled in In re Massey Energy Co. that shareholder suits against
the Massey board of directors could not stop a merger between Massey and Alpha even though
such a merger would render any shareholder action effectively moot for lack of standing [8]
While the Delaware court recognized the potential conflict of interest and inequity, it permitted
the merger to continue on the grounds that Alpha could sue the Massey Board of Directors as the
new owner of the shareholder claim under Del. C. §259(a). [9]

The court cited Lewis v. Anderson when it listed the two exceptions to this strict standing
requirement for shareholder actions after a merger: “(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.” [10] Had Massey attempted the merger solely to
circumvent the shareholder action, the derivative action would have been able to continue under
the first exception listed in Lewis v. Anderson. [11] To prove such an allegation is a tall order
indeed and the court declined to find such a fraudulent abuse of corporate power for the purposes
of granting the injunction against the merger. [12]

This theory of standing during mergers has broad implications for the corporate governance for
publicly traded natural resource companies, food producers, and energy utilities—especially
during disasters or scandals with ongoing shareholder derivative actions. Shareholders should be
aware that they will lose standing for any derivative actions after a merger and such actions will
be transferred as a property right to the new corporation. [13] It is up to the newly merged
corporation to bring its own suit against the very old board of directors that negotiated the
merger deal in the first place, a situation ripe for potential conflicts of interest. [14] The court
also suggested that the Massey shareholders, as new Alpha shareholders after the merger,
demand Alpha bring a suit against Massey directors and officers. If Alpha declined to take
action, then the shareholders could sue the Massey board of directors in what is called a double
derivative suit. [15] In its opinion, the court recognized the improbability of a double derivative
action as a realistic option against the Massey board of directors. [16] The court also pointed out
that value of the director and officer liability insurance should have been priced into the deal
because of the realistic chance of Alpha later recovering it in a suit. [17] With Massey’s director
and officer liability insurance valued at $95 million, this would have represented “no trifle sum”
to Massey shareholders during the $8.5 billion merger. [18]

LaCroix, supra note 2

Seth Aronson et al, Practicing Law Institute, Shareholder Derivative Actions: From Cradle to Grave 325 (2011)

Id.

Id. at 424.


Id.


In Re Massey Energy Co., 2011 WL 2176479 at *3.

Id. at 76.

Id.

Id. at 75-6.

Id. at 74-5.


Id. at 65.

Id.
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