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EXPERT ANALYSIS

Bank of America Merger Shields Countrywide Directors from Pending Suits

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The Delaware Supreme Court ruled Sept. 10 that former shareholders of Countrywide Financial Corp. cannot rely on the "fraud exception" to Delaware's continuous owner-ship rule to maintain a derivative suit by alleging that the merger that divested them of their ownership interest in the corporation was necessitated by, and was inseparable from, the alleged fraud that is the subject of the derivative claims.

In *Arkansas Teacher Retirement System v. Countrywide Financial Corp.*,[1] the Delaware Supreme Court, in a unanimous *en banc* decision, affirmed the "continuous ownership" requirement for standing in order to bring a shareholder derivative suit under Delaware law.

NO STOCK, NO STANDING

The court held that, where the corporation on whose behalf a derivative action is pending is later acquired in a merger that removes the derivative plaintiff's shares, the derivative claim — originally belonging to the acquired corporation — is transferred to and becomes an asset of the acquiring corporation as a matter of statutory law. The original plaintiff loses standing to maintain the derivative action because, as a consequence of the merger, the original derivative shareholder plaintiff can no longer satisfy the continuous ownership requirement.

The Delaware Supreme Court rejected the derivative shareholder plaintiffs' argument that the narrow "fraud exception" to Delaware's continuous ownership rule, as established in *Lewis v. Anderson*,[2] should be read expansively based upon dicta in the court's 2010 opinion in *Arkansas Teacher Retirement System v. Caiafa*,[3] so the shareholders should continue to have standing to maintain a derivative action.

Countrywide, once the nation's largest mortgage lender, suffered disastrous setbacks during the housing market crash. Beginning in October 2007, shareholders filed derivative complaints on behalf of Countrywide against its officers and directors for alleged pervasive fraudulent conduct. The shareholders alleged that the defendants caused Countrywide to dramatically shift its strategic direction away from traditional fixed-rate home loans in favor of a wide range of nontraditional, high-risk loans. The plaintiffs further alleged that because of the defendants' conscious misconduct and abdication of their fiduciary duties, Countrywide's shift to selling riskier products resulted in a reckless foray into predatory lending practices and a failure to protect Countrywide from the increased risks that it was facing.

RISKY BUSINESS

According to the plaintiffs, all of this occurred while the defendants were reaping hundreds of millions of dollars in illegal insider selling while simultaneously causing Countrywide to purchase its stock at inflated prices through a multibillion-dollar buy-back program.

The plaintiffs' allegations gained traction with U.S. District Judge Mariana Pfaelzer, who presided over the consolidated lawsuits in the U.S. District Court for the Central District of California.

"The plaintiffs' allegations create a cogent and compelling inference that the defendants misled the public with regard to the rigor of Countrywide's loan origination process, the quality of its loans, and the company's financial situation," she wrote in a 54-page opinion denying the defendants' motion to dismiss, "even as they realized that Countrywide had virtually abandoned its loan underwriting practices."[4]

Judge Pfaelzer rejected the defendants' arguments that the defendant directors did not know about the problems.

"[T]he idea that a company-wide culture that encouraged unchecked deviations from underwriting standards in a way which would fatally affect the company's continued financial performance went unnoticed by a board of directors," she wrote, "simply does not square with the specific and comprehensive monitoring duties assigned to the members of the board."[5]

SCIENTER INFERRED

Judge Pfaelzer also found that the allegations of massive insider stock sales supported an inference of *scienter*.

Justice Randy Holland, writing for a unanimous, en banc Delaware Supreme Court, made short work of the plaintiffs' argument.

"How could the board members approve a repurchase of $2.4 billion worth of stock, and nearly contemporaneously liquidate $148 million of their personal holdings just months before the stock dropped some 80-90 percent?," she wrote.[6]

"It defies reason, given the entirety of the allegations, that these committee members could be blind to widespread deviations from the underwriting policies and standards being committed by employees at all levels. At the same time, it does not appear that the committee took corrective action."[7]

In January 2008, Countrywide announced its proposed acquisition by Bank of America in a $2.5 billion all-stock merger transaction, representing less than 10 percent of Countrywide's stock value just a year earlier in February 2007.

Following the merger, the District Court granted judgment on the pleadings to defendants on the ground that the plaintiffs lost standing to pursue the derivative claims upon consummation of Countrywide's merger with Bank of America. *In re Countrywide Fin. Corp. Derivative Litig.,* No. 07-06923, 554 F. Supp. 2d 1044 (C.D. Cal. 2008).

While the federal derivative case was proceeding in California, and immediately after the announcement of the merger, Countrywide shareholders sued in Delaware to block the merger. The plaintiffs alleged in the Delaware action that Countrywide's directors breached fiduciary duties owed directly to shareholders by agreeing to inappropriate merger terms and soliciting shareholder approval based on false and misleading proxy materials.

A NEW HOPE IN DICTUM?

On May 21, 2010, the Delaware Supreme Court issued an *en banc* unanimous opinion that affirmed approval of a settlement in the Delaware case challenging the merger. Although the issue of the shareholder plaintiffs' standing to pursue a derivative action was not before the Delaware Supreme Court, the opinion, in dicta, addressed the scope of the "fraud exception" to loss of standing following a merger as well as the plaintiff shareholders' direct causes of action following a merger.

The Delaware high court observed that "[t]he extent of the Countrywide directors' allegedly fraudulent conduct and breach of duties by failing to oversee the company's practices in good faith would have necessitated (a) rescue; and (b) individual legal protection."

"A merger was one of the few available alternatives that meet both of those objectives after the board's allegedly fraudulent schemes bankrupted a multibillion-dollar company," the court wrote. "Delaware law recognizes a single, inseparable fraud when directors cover massive wrongdoing with an otherwise permissible merger. … An otherwise pristine merger cannot absolve fiduciaries from accountability for fraudulent conduct that necessitated that merger."[8]

The Delaware Supreme Court further stated that if pre-merger fraudulent conduct that necessitated the merger was successfully pleaded, the former shareholders, rather than the corporation, could recover directly from the directors: "In that case, the injured parties would be the shareholders who would have post-merger standing to recover damages instead of the corporation."[9]

Following the 2010 *Arkansas Teachers* decision, the plaintiffs filed a motion for reconsideration of the California District Court's judgment on the pleadings, arguing that the plaintiffs satisfied the fraud exception for post-merger derivative standing as clarified in the Delaware 2010 *Arkansas Teachers* decision. The District Court denied the motion, and the plaintiffs appealed to the 9th U.S. Circuit Court of Appeals.

'A SINGLE, INSEPARABLE FRAUD'

On appeal to the 9th Circuit, the plaintiffs argued that, because they alleged "a single, inseparable fraud" by which the defendant Countrywide "directors cover[ed] massive wrongdoing with an otherwise permissible merger,"[10] they maintained post-merger derivative standing under the fraud exception to the continuous ownership rule, as interpreted by the Delaware 2010 *Arkansas Teacher* decision.[11]

The 9th Circuit noted that "the contours of shareholder derivative standing affect the internal affairs of corporations organized under state law" and "implicate significant issues of state public policy best resolved by reference to clear rules of state law."[12] The 9th Circuit also noted that state and federal courts interpreting the scope of the fraud exception to Delaware's continuous ownership rule in light of the Delaware 2010 *Arkansas Teachers* decision have reached divergent results.[13] Therefore, the 9th Circuit certified the question of the plaintiffs' post-merger derivative standing to the Delaware Supreme Court and the plaintiffs returned to the Delaware Supreme Court for a second bite at the apple.

Delaware law, like the Federal Rules of Civil Procedure, requires that, in order to maintain a derivative action, the plaintiff "must not only be a stockholder at the time of the alleged wrong and at the time of the commencement of the suit but … must also maintain shareholder status throughout the litigation."[14] The continuous ownership requirement is a matter of common law.[15]

The Delaware Supreme Court held in *Lewis v. Anderson* "that where the corporation on whose behalf a derivative action is pending is later acquired in a merger that deprives the derivative plaintiff of her shares, the derivative claim — originally belonging to the acquired corporation — is transferred to and becomes an asset of the acquiring corporation as a matter of statutory law. The original plaintiff losses standing to maintain the derivative action, because as a consequence of the merger, the original derivative shareholder plaintiff can no longer satisfy the continuous ownership requirement."[16]

The court in *Lewis* recognized a "fraud exception" to the loss-of-standing rule "where the merger itself is the subject of a claim of fraud, being perpetrated merely to deprive shareholders of their standing to bring or maintain a derivative action."[17]

In the instant case, the plaintiffs sought to avoid the "loss of standing" problem by arguing to the California District Court that the dictum in the Delaware 2010 *Arkansas Teacher* decision represented "a new material change in the law" that "expanded the post-merger standing fraud

Justice Holland explained that the discussion of "inseparable fraud" in the 2010 Arkansas Teacher opinion was referring to direct, not derivative claims.

exception to include situations where … the plaintiffs sufficiently allege fraudulent conduct that necessitated the merger."[18]

The plaintiffs relied on dictum in the decision that discussed "certain direct claims the plaintiffs could have but did not present to the Court of Chancery."[19] In particular, the plaintiffs relied upon language that the plaintiffs "theoretically could have pled a claim for 'a single, inseparable fraud' alleging that pre-merger fraudulent conduct made the merger 'a fait accompli.'"[20]

Justice Randy J. Holland, writing for a unanimous, en banc Delaware Supreme Court, made short work of plaintiffs' argument.

"In [2010] Arkansas Teacher," he wrote, "this court unequivocally stated that Countrywide's merger with Bank of America had extinguished the plaintiffs' standing to pursue derivative claims."[21]

"The plaintiffs' argument … is contradicted not only by our holding in [2010] *Arkansas Teacher* that the Court of Chancery's approval of the merger extinguished the plaintiffs' derivative standing, but also by the language and reasoning of the dictum itself."[22]

DICTATED BY DICTUM?

Justice Holland said the discussion of "inseparable fraud" in the 2010 *Arkansas Teacher* opinion was referring to *direct,* not derivative claims.[23] The court explained, in dictum, that a "stockholder may maintain his suit post-merger 'if the merger itself is the subject of a claim of fraud, being perpetrated merely to deprive stockholders of standing to bring a derivative action.'"[24]

"The conditions necessary to satisfy the fraud exception were not present in this case," Justice Holland wrote, "because the record did not reflect that the [Countrywide] directors prospectively sought and approved a merger, solely to deprive stockholders of standing to bring a derivative action. … Avoiding derivative liability was neither the only nor the principal reason for supporting the transaction."[25]

The most lasting impact of Arkansas Teacher may turn out to be, in retrospect, the court's discussion of the direct cause of action available to shareholders in the post-merger context.

CONCLUSION

As a result of Countrywide's merger with Bank of America, the Countrywide directors effectively escaped the shareholder plaintiffs' pending derivative claims.

The most lasting impact of *Arkansas Teacher* may turn out to be, in retrospect, the court's discussion of the direct cause of action available to shareholders in the post-merger context. Justice Holland explained that the 2010 *Arkansas Teacher dictum* stated "that any injury flowing from the 'inseparable fraud' would be suffered by the shareholders rather than the corporation and any recovery would go to the shareholders rather than the corporation.

"'If the vice chancellor had found that [the plaintiffs] had successfully pleaded [their] fraud claim then [plaintiffs] — rather than Countrywide — could recover from the former Countrywide directors," he wrote. "In that case, the *injured parties would be the shareholders* who would have post-merger standing to recover damages *instead of the corporation.*'"[26]

Consequently, in the future, shareholder plaintiffs pursuing derivative claims in situations where a potential merger could lead to a loss of standing may wish to include allegations supporting parallel, direct shareholder claims. WJ

NOTES

1. *Ark. Teacher Ret. Sys. v. Countrywide Fin. Corp.,* 2013 WL 4805725 (Del. Sept. 10, 2013).
2. *Lewis v. Anderson,* 477 A.2d 1040 (Del. 1984).
3. *Ark. Teacher Ret. Sys. v. Caiafa,* 996 A.2d 321 (Del. 2010).
4. *In re Countrywide Fin. Corp. Derivative Litig.,* 554 F. Supp. 2d 1044, 1057 (C.D. Cal. 2008).
5. *Id.* at 1065.
6. *Id.* at 1067.

[7] *Id.* at 1082.

[8] *Caiafa*, 996 A.2d at 323.

[9] *Id.* at 324.

[10] *Id.* at 323.

[11] *Ark. Teacher Ret. Sys. v. Mozilo,* 705 F.3d 973, 974 (9th Cir. 2013).

[12] *Id.* at 975.

[13] *See Villari v. Mozilo,* 208 Cal. App. 4th 1470, 146 Cal. Rptr. 3d 556 (Cal. Ct. App., 2d Dist. 2012); *In re Massey Energy Co. Derivative & Class Action Litig.,* 2011 WL 2176479 (Del. Ch. 2011); *In re Bear Stearns Cos., Sec., Derivative and ERISA Litig.,* 763 F. Supp. 2d 423 (S.D.N.Y. 2011).

[14] *Ark. Teacher*, 2013 WL 4805725 at *3 (quoting *Lewis v. Anderson,* 477 A.2d 1040).

[15] *Id.* at *4.

[16] *Id.* (citing *Lewis v. Anderson*, 477 A.2d at 1149-50; Del. Code Ann. tit. 8, § 259).

[17] *Ark. Teacher,* 2013 WL 4805725 at *5.

[18] *Id.* at *4.

[19] *Id.* at *3 (citing *Caiafa*, 996 A.2d at 322-24).

[20] *Id.* (quoting *Caiafa*, 996 A.2d at 322).

[21] *Id.* at *5.

[22] *Id.*

[23] *Id.*

[24] *Id.* (quoting *Caiafa*, 996 A.2d at 323).

[25] *Id.*

[26] *Id.* at *7 (quoting *Caiafa*, 996 A.2d at 323-24).

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