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Chancery Court Dismisses Inseparable Fraud Claim Based on Derivative Claims That Former Shareholders Lacked Standing To Maintain

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In *In re Massey Energy Company Derivative And Class Action Litigation*, C.A. No. 5430-CB (Del. Ch. May 4, 2017), the Chancery Court dismissed both the direct class action claim for "inseparable fraud" and the derivative claim brought by the former shareholders of Massey Energy ("Massey" or the "Corporation") against the former directors and officers of Massey for breaching their fiduciary duties by causing Massey to operate in willful disregard of safety regulations. The court dismissed the derivative claim holding that the plaintiffs were not continuous shareholders, and therefore lacked standing to bring a derivative claim after Massey merged into Alpha Natural Resources, Inc. (Alpha) in June of 2011. The court dismissed the plaintiffs' direct claim for "inseparable fraud" claim holding that, though pled as a direct claim, it was, in fact, also a derivative claim that the plaintiffs' lacked the standing to maintain.

In this action, Shareholders filed a number a derivative claims to recover damages for expected fines, judgments and other losses caused by the alleged failure of Massey's directors and officers to ensure compliance with mine safety regulations. The Shareholders alleged that under Massey's former CEO, Don L. Blankenship, the corporation manifested "hostility toward regulatory compliance and safety." This was evidenced by, among other things, a determination by the Mine Safety and Health Administration (MHSA) determined that Massey maintained a separate set of production and maintenance books to provide to MSHA that underreported safety violations. For example, in 2009 alone, Massey received 10,653 citations from MSHA. In addition, in April 2010, an explosion at Massey's Upper Big Branch coal mine (UBB) in West Virginia killed 29 miners. Both government and private reports concluded "that Massey knowingly flouted the law and caused the UBB disaster by ignoring safety requirements and actively subverting regulatory enforcement." Don Blankenship, amongst others, was convicted of criminal offenses.

Shortly after the UBB explosion, Alpha proposed to acquire all Massey stock. Though the board initially rejected Alpha's overtures, Alpha persisted and made several offers to purchase Massey in the latter half of 2010. After Blankenship was persuaded to retire, the board's strategic alternatives committee decided to solicit bids from three interested strategic acquirors. Ultimately, the board unanimously approved a merger with Alpha that closed on June 1, 2011, after the Court of Chancery had denied plaintiffs' motion for a preliminary injunction. The plaintiffs' action was then stayed until July 2016, first at the request of the U.S. Attorney's office investigating the defendants, and then by the automatic stay imposed when Alpha filed for bankruptcy. The stay was lifted in July 2016 when the bankruptcy court approved Alpha's plan of reorganization.

The court dismissed the plaintiffs' derivative claims because the plaintiffs' lacked standing under well-settled Delaware law requiring a derivative plaintiff to be a shareholder throughout the litigation. Standing is lost when shareholders surrender their stock as a result of a merger, unless the merger itself is a fraud intended "merely to deprive shareholders of the standing to bring a derivative action," or the merger is simply a reorganization that does not impact the plaintiffs' ownership of the corporation. The plaintiffs' did not argue that either exception applied, waiving the issue, and ultimately acknowledged that they were not arguing that the derivative claim had survived the merger. After dismissing the derivative claims with prejudice as to the plaintiffs, the court noted that Alpha inherited the derivative claims in the merger and could still pursue the derivative claims itself.

To avoid this standing issue, the plaintiffs' argued that they had stated a direct claim for "inseparable fraud." Following and applying precedent and Delaware Supreme Court dictum, the Court of Chancery concluded that to state a claim for inseparable fraud requires facts from which it is reasonably conceivable that (1) a defendant engaged in serious misconduct before a merger that gives rise to a *direct* claim and (2) the merger must have been necessitated or made "inevitable" by that misconduct.

Under existing precedent, the Court of Chancery stated that it determines whether a particular claim is direct or derivative by considering only (1) who suffered the alleged harm (the corporation or the suing stockholders, individually) and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually). Summarizing the plaintiffs' allegations to be "that the defendants breached their fiduciary duties by employing a 'deliberate and systematic business plan of willfully disregarding both internal and external safety regulations' for several years before the Merger, the Court of Chancery concluded that the claim, though cast as a direct claim, was in fact derivative. Noting that implementation of a business plan implicates mismanagement, the court held that the allegations concerned the directors' duty to manage the corporation – a duty that is owed to the corporation. Moreover, the harms identified were corporate harms such as fines and penalties imposed on Massey that would be paid by Massey. Similarly, recovery against the directors for such harms would properly go to Massey, as the entity paying the fines and penalties, rather than the shareholders. In short, the complaint did not allege that the directors "engaged in misconduct to secure personal benefits for themselves to the detriment of any Massey stockholder separately or individually." Accordingly, the complaint failed to allege facts supporting a *direct* claim as required to state a claim for "inseparable fraud." Because the lack of a direct claim was dispositive, the Court dismissed the claim without considering whether the alleged mismanagement of Massey necessitated the merger with Alpha.

The court also rejected the plaintiffs' public policy argument that dismissing their causes of action would amount to allowing the defendants to evade responsibility for their mismanagement because the defendants had been held accountable in the form of criminal prosecutions, and securities fraud actions. Further, they remained accountable to Alpha as the sole shareholder of Massey in a derivative suit. Finally, though it dismissed the complaint on other grounds, the court rejected the defendants' argument that shareholder approval of the merger warranted dismissal because approval by disinterested stockholders can justify the economic merits of a transaction, but does not shield all board actions so long as they are approved by the shareholders.

Russel Deutsch contributed to this post

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