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EXECUTIVE RISKS
# ALERT

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# DETAILS IN DELAWARE

## WHEN IS A DERIVATIVE CASE NO LONGER A DERIVATIVE CASE? WHEN A SHAREHOLDER IS NO LONGER A SHAREHOLDER.

A recent court decision in a Directors & Officers (D&O) derivative claim case reminds us of an often overlooked clause in a Delaware law that governs much D&O derivative claim activity: a plaintiff in a derivative action must not only be a shareholder when the litigation commences, but *throughout the suit as well*. In *Grosset v. Wenaas*,[1] the acquisition of the defendant company effectively extinguished the ongoing derivative claim, because, after the acquisition, the plaintiff was no longer a shareholder. This requirement, known as the continuous ownership rule, has the potential to impact many D&O derivative claims because so many firms are incorporated in Delaware.

In the context of mergers and acquisitions, Delaware recognizes two limited exceptions to the rule. The first applies where the merger itself is the subject of a claim of fraud, perpetrated to deprive shareholders of standing or the ability to bring a derivative action. The second applies where the merger is really a reorganization that does not affect the plaintiff's ownership in the business enterprise.

The purpose of the rule is to prevent strike suits, where stock in a corporation is purchased with purely litigious motives; that is, for the sole purpose of bringing a derivative action to attack transactions that occurred prior to the stock purchase.

The rule highlights an important difference between D&O derivative claims and D&O securities class actions. In the former, the plaintiff must be a shareholder *at the time* that the action is brought; in the latter, the plaintiff must have sold his or her holdings *prior to* bringing the suit.

> The term *derivative action* refers to "a suit by a shareholder to enforce a corporate cause of action. The corporation is a necessary party, and the relief which is granted is a judgment against a third person in favor of the corporation. An action is a derivative action when the action is based upon a primary right of the corporation, but is asserted on its behalf by the stockholder because of the corporation's failure, deliberate or otherwise, to act upon the primary right." (*Black's Law Dictionary*)

Derivative claims are of special interest to directors and officers, as court awards or settlements are generally non-indemnifiable and therefore fall under what is known as the *A-Side* of a D&O policy or under a stand-alone A-Side D&O contract. A-Side coverage is designed for just such situations.

For more on derivative claims, see our *Executive Risks Alert*, "Anatomy of a Derivative Claim."

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[1] Richard Grosset filed a shareholder's derivative action on behalf of JNI Corporation against certain of its directors and officers alleging breach of fiduciary duty, waste of corporate assets, gross mismanagement of JNI, and insider trading in connection with a secondary offering by JNI. After the litigation began, the stockholders of JNI voted to approve a merger. Applied Micro Circuits Corporation purchased all outstanding shares of JNI stock, including Grosset's.