UNITED STATES DISTRICT COURT

CENTRAL DISTRICT OF CALIFORNIA

In re COUNTRYWIDE FINANCIAL CORP. DERIVATIVE LITIGATION	**Lead Case No. CV-07-06923-MRP (MANx)** **ORDER GRANTING INDIVIDUAL DEFENDANTS' MOTION FOR JUDGMENT ON THE PLEADINGS CONCERNING PLAINTIFFS' DERIVATIVE CLAIMS**

INTRODUCTION

This Court has consolidated numerous actions related to Countrywide Financial Corporation ("Countrywide I") into three cases pending before it. The present case involves institutional investors ("Plaintiffs") that were at first pursuing only state law derivative claims in this Court.[1] Plaintiffs pressed the claims on behalf of Countrywide I against certain of its then-current and former directors ("Individual Defendants"). In January 2008, several months after this litigation began, Countrywide I announced its intent to merge into a subsidiary of Bank of America ("BofA").

After the merger was announced, Plaintiffs amended their complaint to include federal derivative claims, federal class action claims, and state class action claims. The class action claims—both federal and state—in this case are stayed in

[1] *See In re Countrywide Fin. Corp. Derivative Litig.*, 554 F. Supp. 2d 1044 (C.D. Cal. 2008) (explaining the case history in more depth).

favor of parallel proceedings in the Delaware Court of Chancery. *In re Countrywide Fin. Corp. Derivative Litig.*, 542 F. Supp. 2d 1160, 1174 (C.D. Cal. 2008). This order addresses only the derivative claims, both federal and state, none of which were stayed.

On July 1, 2008, Countrywide I completed a forward triangular merger into a subsidiary of Bank of America called Red Oak Merger Corporation ("Red Oak"). To effect the merger, Countrywide I shareholders received shares of BofA in exchange for their Countrywide I shares. Red Oak was then renamed Countrywide Financial Corporation ("Countrywide II"). Countrywide Fin. Corp., Form 10-Q (Aug. 11, 2008).

Individual Defendants move for judgment on the pleadings on Plaintiffs' derivative claims (Counts I-III and V-IX[2]). Defendants move on the ground that the recent merger eliminated Plaintiffs' standing to assert those claims on Countrywide I's behalf. Plaintiffs respond that this Court should apply a purported equitable exception under Ninth Circuit law to allow them to proceed with the derivative claims.

For the reasons that follow, the Court GRANTS Individual Defendants' motion for judgment on the pleadings for the derivative claims. The class action claims remain stayed.

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[2] Count IV was dismissed in its entirety and some defendants have been dismissed from the other derivative claims. *See In re Countrywide Fin. Corp. Derivative Litig.*, 554 F. Supp. 2d 1044 (C.D. Cal. 2008). Count IV, had it not been dismissed earlier on other grounds, would require separate treatment because it asserted a California securities law. *Id.* at 1079.

I.

RELEVANT FACTUAL BACKGROUND

Countrywide I, like Countrywide II and BofA, was a Delaware corporation, the internal affairs of which are governed by Delaware substantive law.[3] At least three separate venues have seen derivative claims related to the merger: this Court, a United States District Court in Delaware, and the Delaware Court of Chancery. The Chancery Court has before it merger-related class action claims in a consolidated case herein referred to as "*Freedman*." *In re Countrywide Corporation Shareholders Litigation*. C.A. No. 3464-VCN. Meanwhile, the Delaware District Court had before it only a merger-related state derivative claim. That state claim—quite similar to some of the state claims pressed in this case—was brought by a different group of institutional investors. The Delaware District Court dismissed the derivative claim for lack of standing. *In re Countrywide Fin. Corp. Derivative Litig.*, 2008 WL 4488907, 2008 U.S. Dist. LEXIS 79725 (D. Del. Oct. 7, 2008).

Nevertheless, Plaintiffs seek to take advantage of a potential conflict between Third Circuit law (where the Delaware District Court sits) and Ninth Circuit law so that their claims do not meet the same fate as those of the similarly situated institutional investors in the Delaware District Court. As explained below, the Ninth Circuit law that controls this Court can be read to treat Defendants'

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[3] Plaintiffs do not contest Defendants' use of Delaware authorities on choice of law principles. This is likely because the California Supreme Court earlier this year unanimously interpreted the relevant California Corporations Code provision in line with Delaware authority to avoid the issue. *Grosset v. Wenaas*, 42 Cal. 4th 1100, 1107 (2008) (stating the "internal affairs doctrine"); *id.* at 1111 (explaining differences and potential differences between the California and Delaware Codes); *id.* at 1119 (endorsing Delaware law on point and avoiding the choice of law issue in a situation comparable to the parties' here). This Court expresses no opinion on the choice of law issue, except to note that both California and Delaware would reach the same result in this context.

standing arguments as governed by federal procedural law. The Delaware District Court treated—and other Circuits appear to treat—the question as one of Delaware substantive law. Because some of the Plaintiffs' derivative claims arise under state law, this Court must apply the relevant state law if that law is substantive in nature. *Erie Railroad Co. v. Tompkins*, 304 U.S. 64 (1938); *Vess v. Ciba-Geigy Corp. USA*, 317 F.3d 1097, 1102 (9th Cir. 2003) ("*Erie* applies irrespective of whether the source of subject matter jurisdiction is diversity or federal question.").

This Court only observes the potential conflict; it does not seek to resolve it; or, if the conflict is real, to express an opinion on its proper resolution. The Court performs its analysis under both approaches. Regardless of the approach used, the result is the same: Plaintiffs' derivative claims are dismissed in their entirety. Plaintiffs' class action claims remain stayed pending the outcome of the *Freedman* proceedings.

II.

LEGAL BACKGROUND

Federal Rule of Civil Procedure 23.1, by its terms, requires only that a derivative plaintiff plead, in a verified complaint, that he was a shareholder at the time of the alleged wrong. Fed. R. Civ. P. 23.1(b)(1) (requiring the complaint "allege that the plaintiff was a shareholder or member *at the time of the transaction complained of* . . . .") (emphasis added).[4] Rule 23.1(b)(1) thus requires a plaintiff to

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[4] The quoted language is from the Rule as amended effective December 1, 2007 in a "general restyling of the Civil Rules to make them more easily understood and to make style and terminology consistent throughout the rules." Adv. Comm. Note to Fed. R. Civ. P. 23.1. The changes were intended to be stylistic, not substantive. *Id.* The only difference is that the old Rule was more verbose in an effort to avoiding ending the relevant clause with a preposition: the plaintiff had to allege that he was "a shareholder or member at the time of the transaction of which the plaintiff complains . . . ." Fed. R. Civ. P. 23.1(1) (1987).

plead that he meets a test for standing known as the "contemporaneous ownership requirement."

Delaware—and most other jurisdictions—have a "continuous ownership requirement" as well as the contemporaneous ownership requirement. The general continuous ownership rule is that a plaintiff must hold her interest in the corporation throughout the entire litigation. *Lewis v. Anderson*, 477 A.2d 1040 (Del. 1984). Today, "it is well established that a merger which eliminates a derivative plaintiff's ownership of shares of the corporation for whose benefit she has sued terminates her standing to pursue those derivative claims." 852 A.2d 896, 904 (Del. 2004). This strict rule is subject only to two exceptions: (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." *Anderson*, 477 A.2d at 1046 n.10.

A 1983 Ninth Circuit decision established that a continuous ownership requirement is, in this Circuit, "inferred from" Rule 23.1's contemporaneous ownership pleading requirement. *Lewis v. Chiles*, 719 F.2d 1044, 1047 (9th Cir. 1983). The *Chiles* case was careful to distinguish the contemporaneous and continuous ownership concepts and treat them separately. *Id.* Later cases, however, began to lump the two concepts together as "continuous ownership." The distinction became important after the Ninth Circuit in 1999 became the first and only Circuit clearly to hold that Rule 23.1 is a rule of procedure, not substance, under the *Erie* Doctrine. *Kona Enters., Inc. v. Estate of Bishop*, 179 F.3d 767 (9th Cir. 1999).[5]

The *Kona* panel at one point states, "Rule 23.1's continuous share ownership requirement is procedural in nature and thus applicable in diversity actions." *Id.* at

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[5] *But see Cadle v. Hicks*, 272 Fed. Appx. 676 (10th Cir. 2008) (unpublished, nonprecedential opinion citing *Kona*'s *Erie* holding in a contemporaneous ownership case).

769 (emphasis added). *See also* James D. Cox & Thomas Lee Hazen, *Corporations* § 15.07 p. 449-50 (2d ed. 2002) (citing *Kona* and noting that only the Ninth Circuit has "definitively ruled" on whether the contemporaneous ownership requirement and that other Circuits appear to treat the continuous ownership requirement as substantive); 7C Charles Alan Wright, et al., Federal Practice and Procedure § 1829 (West 2008) (explaining the considerations, citing *Kona* as the only appellate case directly on point, but discussing only contemporaneous ownership).

Despite the word "continuous" in the above quotation from *Kona*, the *Kona* panel had before it a case of contemporaneous—not continuous—ownership. 179 F.3d, at 769-70. Indeed, the *Kona* panel also summarized its holding much more narrowly, explaining, "failure to own stock . . . contemporaneously with bringing suit deprives them of standing to pursue their claims derivatively." *Id.* at 769 (emphasis added). The panel then noted that some states have "less demanding standards" for derivative plaintiffs' standing, but even in those states, the "law would likely cause us to reach the same result" as *Kona*. *Id.*

Those "less demanding standards" were both variations of contemporaneous ownership: owning an interest in the company (1) at "the time of the transaction(s) complained of"—the same as the text of Rule 23.1(b)(1); and (2) "at the time the suit is filed"—that is, a contemporaneous ownership test that looks at the time of filing but does not require continuous ownership for the entire duration of the litigation. *Id.* This suggests that the *Kona* panel may not have fully appreciated the distinction between contemporaneous and continuous ownership. *Kona*'s same-result reasoning may not hold when, as here, continuous ownership is in question.

Plaintiffs here held their interests in Countrywide I both at the time of the transaction and at the suit's filing. Thus, they meet the two possible contemporaneous ownership tests *Kona* discusses, but not a continuous ownership test.

No case this Court can find has applied the *Kona* rule in a continuous ownership situation where the claim arises under state law. It is likely, however, that if the letter of Rule 23.1 is procedural, as *Kona* unquestionably holds, then the continuous ownership requirement implied from an otherwise straightfoward pleading rule would be procedural as well.

Kona differs from Delaware law in two relevant ways. First, *Kona* has a merger exception that Delaware lacks: *Kona* might allow courts discretion to grant "equitable standing" in merger cases if "plaintiffs contend[] they had lost their stock due to the same wrongful conduct that was the subject of the derivative suit they were trying to bring." *Id.* at 770. However, *Kona* and the cases it cites might be read to stand for the even broader principle that equitable standing can be granted in any merger case. *Id.* (noting that the cases giving rise to its merger exception focus on "the company on whose behalf the plaintiffs were suing had disappeared," which is true in any merger); *Miller v. Steinbach*, 268 F. Supp. 255, 267-70 (S.D.N.Y 1967) (suggesting that the court would consider equitable standing for almost any situation that might be counter to a broad interpretation of the "purpose" of the federal securities laws). It is this possible broad reading of the "merger" equitable exception that Plaintiffs seize upon here. Second, *Kona* is silent about Delaware's functional reorganization exception.[6]

It is under *Kona*'s potential merger exception that Plaintiffs in this case seek a result opposite to that reached by the District Court in Delaware, at least as to the state law claims.

[6] *Kona* appears to have a foreclosure or forced sales exception similar to that of Delaware. *Id.* at 770 (citing *Eastwood v. Nat'l Bank of Commerce,*, 673 F. Supp. 1068 (W.D. Okla. 1987)).

III.

DISCUSSION

State law derivative claims: Under either the *Kona* analysis or the Delaware state law analysis used by the District Court in Delaware, Plaintiffs' state law claims fail for lack of continuous ownership. Even if this Court has equitable power to allow Plaintiffs to retain standing for their state derivative claims under *Kona*, it would not exercise that power. Thus, this Court need not decide whether the Ninth Circuit meant *Kona* to apply in true continuous ownership cases; and, if *Kona* is not meant to apply, whether continuous ownership is a matter of substantive state law under *Erie*. The Court only notes that, if applied to continuous ownership cases, *Kona* appears to invite a split in authority.

Federal law derivative claims: As for Plaintiffs' federal derivative claims, the *Kona* analysis below is controlling. Even if the Court has equitable power to allow Plaintiffs to retain standing for their federal derivative claims under *Kona*, it declines to exercise that power.

A. Analysis under *Kona*

The following analysis applies to Plaintiffs' federal derivative claims. Assuming, but not deciding, that *Kona* makes Federal Rule 23.1(b)(1) governing law over state claims, the following analysis would apply to the state claims as well.

Plaintiffs concede that the "continuous ownership" requirement would generally prevent them from proceeding with the derivative claims because the merger eliminated their Countrywide I shares and thus terminates their standing to pursue derivative claims as Countrywide I shareholders. *See* Pl.s' Opp. at 1. The only question here is whether this case merits an "equitable exception" to the general rule because Plaintiffs' loss of standing would lead to an inequitable result.

The Court assumes, *arguendo*, that it has discretion to grant the equitable exception that Plaintiffs seek. *Cf. LeBoyer v. Greenspan*, 2007 WL 4287646, at *4-

5, 2007 U.S. Dist. LEXIS 96231, at *14-15 (C.D. Cal. June 12, 2007) (despite the Ninth Circuit's pronouncement of an equitable exception, finding no Ninth Circuit decisions that actually awarded a plaintiff standing on equitable grounds). The Court concludes that, even if it has the equitable discretion Plaintiffs claim, the Court would not exercise it here.

At the time of suit, the derivative claims proceeding in this Court were intangible assets belonging to Countrywide I. Those assets transferred from Countrywide I to Red Oak (now Countrywide II) upon consummation of the merger. At that moment, Countrywide I shareholders no longer had a legal interest in the claims; rather, the claims became part of Red Oak, the sole owner of which was BofA. *See Countrywide*, 542 F. Supp. 2d at 1175. *See also Chiles*, 719 F. 2d at 1047 (9th. Cir. 1983).

Plaintiffs in essence ask the Court to withdraw the derivative claims from the pool of assets transferred to BofA's subsidiary. This could possibly be equitable only if (1) the value of the derivative claims was not included in the consideration paid to former Countrywide I shareholders for their Countrywide I shares; and (2) that consideration, even if it did not account for the value of the derivative claims, was not at least as valuable as the value of Countrywide I, including the derivative claims.

However, other plaintiffs have already brought claims on behalf of the former Countrywide I shareholders—claims that squarely target the unfairness of the consideration. Those claims are part of the *Freedman* case now proceeding in the Delaware Court of Chancery.

The *Freedman* plaintiffs brought a direct class action claim against Countrywide I directors for breach of fiduciary duty in agreeing to the merger. *Freedman*, Consol. Verified Class Action Compl. ¶¶ 126-34. The *Freedman* plaintiffs have proposed a settlement, but the Vice Chancellor is currently hearing

the objection of the very same Plaintiffs now before this Court as to the consideration BofA paid for Plaintiffs' Countrywide I shares.[7]

The Court finds that Delaware proceedings in *Freedman* sufficiently protect against the potential inequity that could occur here.[8] The Delaware courts are well accustomed to valuing consideration in merger cases. Though irrelevant to the Court's finding that Delaware procedures would protect the instant Plaintiffs, the Court further observes that the Vice Chancellor in *Freedman* took the unusual step of granting the instant Plaintiffs discovery on their settlement objection. Trans. of Hearing at 11-12, 07-06923-MRP (C.D. Cal. July 8, 2008) (counsel for Plaintiffs discussing the Chancery proceedings). The Vice Chancellor has heard Plaintiffs' arguments and taken them under submission. Trans. of Settlement Hearing, C.A. No. 3464-VCN (Oct. 28, 2008). Thus, the Plaintiffs will not be heard to protest that the Vice Chancellor is not taking their arguments about the proper valuation of Countrywide I shares seriously. *See also* Trans. of Hearing 07-06923-MRP (C.D. Cal. July 8, 2008) at 17-19 (counsel for Plaintiffs explaining for this Court the arguments they are making to the Vice Chancellor).

To be clear: even if the Vice Chancellor had not granted Plaintiffs discovery on their objection, and he had held more abbreviated settlement fairness proceedings, the Court would still find the that the Delaware courts' procedures would protect Countrywide I's former shareholders. *See, e.g.*, *Kahn v. Sullivan*,

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[7] Delaware law appears to prefer such direct shareholder class action challenges to derivative actions by design. *See LeBoyer*, 2007 WL 4287646, at *5, 2007 U.S. Dist. LEXIS 95121, at *16-17; *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031 (Del. 2004).

[8] This is precisely the determination that this Court made in March. *See* 542 F. Supp. 2d at 1177 ("[O]ther proceedings contemplate the extinction of the derivative suits and already seek equitable and legal remedies, as necessary, for shareholders to the extent that the derivative suits are not properly valued by the acquisition price.").

594 A.2d 48, 58-59 (discussing Delaware's settlement approval procedures and protections).

Moreover, if Plaintiffs prevail on the derivative claims here and in their *Freedman* objection, Countrywide I's former shareholders would essentially recover twice for the same alleged injury: once from this Court for the derivative claims; and once from the Chancery Court for the failure of Red Oak / BofA to pay them for the derivative claim "assets" that were transferred to Red Oak. That result would itself be an inequity—and a naked wealth transfer from BofA shareholders.[9]

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[9] If the Vice Chancellor in *Freedman* finds that the derivative claims were fairly valued in the merger consideration (and settlement), and therefore now properly exist as assets of Countrywide II, all recourse is not lost. In a stock-for-stock triangular merger such as this one, the former stockholders of the target corporation are now stockholders of acquiring parent corporation. Because all the assets and liabilities of the target are now part of the acquiring corporation's subsidiary, any claims the target had are now (indirect) assets of the acquiring corporation. If the acquiring corporation fails to make use of that asset by refusing to bring the suit, the shareholders of the acquiring corporation—including both the former shareholders of the target corporation as well as the shareholders of the acquiring corporation—might bring a "double derivative" action to compel the acquiring corporation to bring the suit. The action is "double" because it forces (1) the acquiring corporation's board to (2) compel its subsidiary to bring suit. A double derivative ensures that all relevant classes of shareholders—here, the shareholders that have only held BofA shares as well as those who had their Countrywide I shares exchanged for BofA shares—are protected.

It also allows the acquiring corporation's management to take advantage of the business judgment rule and any other doctrines that may be available. This is so even here, where BofA has agreed to indemnify Countrywide I's officers and directors: if that indemnity shows, as Plaintiffs repeatedly argue, that BofA will never pursue the claims of the target, then there arises a question of the fiduciary duties of BofA's directors; and those duties, again, are owed to all BofA shareholders, not just those who formerly held shares of Countrywide I. A derivative action against BofA for the indemnity, or a double derivative against BofA for not exploiting the derivative claims that now reside in Countrywide II, of course, would require a separate action and perhaps different lawyers would receive lead counsel status. As to the shareholders themselves, either action should

Because this Court has no reason to question whatever decision the Court of Chancery in *Freedman* may reach, the Court refuses to exercise the equitable discretion Plaintiffs claim it has.

B. Analysis if *Kona* does not govern the state law claims

Assuming, but not deciding, that *Kona* holds that Federal Rule 23.1(b)(1) governs only as to contemporaneous, but not continuous, ownership cases, this Court would adopt the reasoning of the District Court in Delaware insofar as it states and applies the governing Delaware state law on continuous ownership. *In re Countrywide Fin. Corp. Derivative Litig.*, 2008 WL 4488907, 2008 U.S. Dist. LEXIS 79725 (D. Del. Oct. 7, 2008). Even if continuous ownership is not governed by Delaware law as an issue of the internal affairs of a Delaware corporation, the Court still would adopt the Delaware District Court's reasoning under *Erie* because California, where this Court sits, would reach the same result and likely use the same Delaware authorities. *Grosset v. Wenaas*, 42 Cal. 4th 1100 (2008) (unanimously approving Delaware law on this point).

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be capable of achieving substantially the same result. *See Lewis v. Ward*, 852 A.2d 896, 906 (Del. 2004), *Rales v. Blasband*, 634 A.2d 927, 934-35 (Del. 1993).

IV.

CONCLUSION

The Court GRANTS Individual Defendants' Motion for Judgment on the Pleadings Concerning Plaintiffs' Derivative Claims, and accordingly enters judgment in favor of Defendants on Counts I-III and V-IX in Plaintiffs' Consolidated Shareholder Derivative Action and Class Action Complaint. Claims X-XIII remain stayed in favor of *Freedman*.

IT IS SO ORDERED.

DATED: December 11, 2008

Mariana R. Pfaelzer
Hon. Mariana R. Pfaelzer
United States District Judge