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ABCs of shareholder derivative litigation: Part I

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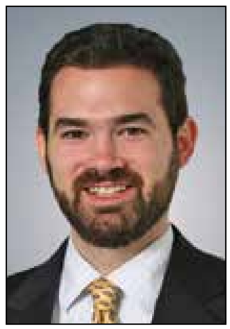
For nearly 200 years, corporate shareholders have employed shareholder derivative actions to vindicate their rights by bringing a lawsuit on the corporation's behalf. Minnesota courts have approved shareholder derivative actions since the late 19th century, while simultaneously voicing concerns about the potential for derivative actions to serve as strike suits to force the corporation to settle. And notwithstanding developments in legal doctrine intended to prevent abuses, shareholder derivative actions continue to proliferate today.

In this two-part series, we classify the new variations of shareholder derivative suits, as well as potential defenses to these claims, into something simple: the ABCs. In this Part, we show how, each new category of derivative suit corresponds to a particular corporate crisis or allegation of corporate wrongdoing: **A**ccounting restatements, **B**ribery allegations, **C**ompensation for executives, and **D**ata breaches. In Part II next week, we will continue alphabetically with defenses to these suits from the corporate perspective: the Demand requirement, Exculpation provisions in the entity's Articles of Incorporation, and Forming a special litigation committee to investigate.

A. Accounting restatements

For years, the Securities and Exchange Commission (SEC) has required public companies to restate their financials if errors have occurred in previously issued statements. Reasons for restating range from simple mathematical errors, to revised



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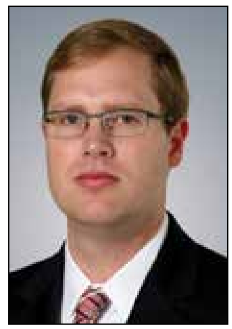

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accounting positions made with the benefit of hindsight, to potentially illegal or fraudulent activity. Restated financials often result in a shareholder derivative suit alleging that the Board of Directors breached a fiduciary duty of care or oversight by failing to monitor the corporation's financial activities. Such actions also typically allege that the company's audit committee members failed to erect or monitor sufficient internal controls.

The case of *Campbell v. Weihe Yu*, 25 F. Supp. 3d 472 (S.D.N.Y. 2014), is an example of this first category. In March 2011, New Energy Systems Group filed its annual report with the SEC disclosing that there was a "material weakness" in New Energy's internal controls over financial reporting and that its internal controls were not effective. Several months later, New Energy filed amendments to its 2009 annual report and to quarterly reports for the first three quarters of 2010, in which it restated the financial statements and revised certain disclosures. The financial statements corrected certain accounting errors to comply with generally accepted accounting principles

Shareholders brought a derivative suit, alleging that the directors and officers breached fiduciary duties. The Southern District of New York granted New Energy's motion to dismiss, however, concluding that the shareholder had not properly made demand and had not sufficiently alleged specific facts showing that a demand would have been futile. As frequently occurs, the Court dismissed the plaintiff's claims because the complaint did not "establish any notice of illegality or fraudulent conduct" on the part of the board, or otherwise plead specific facts showing demand was excused.

In the last several years, Federal courts in numerous states—including California, Connecticut, Illinois, Massachusetts, New York, Texas, and Virginia—have all dismissed accounting restatement cases for similar, demand-related reasons. While the circumstances underlying the restatements differ, the allegations are the same—that directors or officers of a company breached fiduciary duties by failing to maintain proper internal financial controls.

B. Bribery/FCPA allegations

Congress enacted the Foreign Corrupt Practices Act (FCPA) in 1977, which, in short, makes it illegal for public companies to bribe foreign officials. And when allegations of bribery or other corruption proscribed by the FCPA surface, shareholder derivative claims have become increasingly common side effects.

Recent derivative cases show an emerging pattern. First, a public company announces in a 10-K or other public filing that it is setting aside money in connection with a potential settlement with the federal government over alleged FCPA violations. Once the settlement is finalized and publicly announced, shareholders bring a derivative suit, claiming that the corporation's board of directors breached fiduciary duties, committed corporate waste, and/or unjustly enriched themselves by allowing the illegal conduct to occur. The suits are often based on Delaware law (where the companies tend to be incorporated), and allege so-called *Caremark* claims—i.e., that the corporation failed to properly monitor or oversee the actions of its foreign subsidiaries or affiliates.

In the last five years alone, federal courts in numerous states have considered a similar factual scenario. In Texas, for example, the court in *Freuler v. Parker*, 803 F. Supp. 2d 630 (S.D. Tex. 2011) granted a motion to dismiss a shareholder derivative suit alleging breaches of fiduciary duties following an FCPA settlements with the government. It applied the Caremark standard—known as one of the most difficult theories in corporation law upon which a plaintiff might hope to win a judgment—and dismissed the case for failure to make demand upon the Board or show that demand was futile.

Federal courts in California, Nevada, Massachusetts, and Louisiana have all reached similar conclusions. While the cases involve different companies across different industries and different allegations of wrongdoing, they all share a common theme: shareholders allege the Board of Directors breached fiduciary duties following FCPA settlements with the government. These cases are also similar in their result: all were dismissed for failure to make demand and failure to plead particularized facts showing demand would be futile.

C. Compensation

In 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act, one provision of which spawned a third new category of shareholder derivative cases: those involving allegedly excessive executive compensation. Section 951 of the Act requires publicly held corporations to hold advisory, "say-on-pay" votes every three years. This provision appears have been an attempt to give shareholders greater voice into executive compensation, while making clear that the decision on executive compensation still rests with each corporation's board of directors.

Notwithstanding provisions preserving boards' decision-making powers, shareholders began bringing derivative suits immediately following the act's passage. These cases also follow a typical pattern. Prior to an annual meeting, the board recommends approval of a package of compensation for its executives, but a majority of shareholders rejects the recommended compensation in the advisory, "say-on-pay" vote. One or more shareholders then brings a derivative suit, alleging that the board is breaching fiduciary duties, committing corporate waste, and/or unjustly enriching themselves by having recommended (or approved) a package of executive compensation that a majority of shareholders rejected.

An early case gave this dubious type of derivative claim some credence. In *NECA-IBEW Pension Fund v. Cox, the Southern District of Ohio* denied a motion to dismiss shareholder derivative claims in a suit brought following a negative say-on-pay vote at Cincinnati Bell, Inc., in which 66 percent of shareholders voted against the proposed executive compensation package. Applying Ohio law, the court concluded that the allegations raised a plausible claim that the board breached fiduciary duties. Likewise, the court concluded that the complaint alleged sufficient facts to give reason to doubt that the directors could make unbiased, independent business judgments about whether to sue, such that a pre-suit demand would have been futile.

Following the *Cincinnati Bell* decision, shareholders attempted to make similar arguments in other forums, to near universal failure. Federal courts in Oregon, Maryland, California, and Delaware, and state courts in California, Georgia, Minnesota, and elsewhere, have all rejected the outcome in Cincinnati Bell and concluded that a negative "say-on-pay" vote, without more, is not sufficient to state a derivative claim for breach of fiduciary duty or unjust enrichment.

D. Data breaches

The newest category of shareholder derivative case arises out of Data breaches. When retailers, financial institutions, and other public companies announce that the confidential (and often, financial or credit card) information of their customers has been stolen, shareholders allege that directors or officers breached fiduciary duties in failing to implement proper data security measures. Given the growing frequency of data breaches and the significant financial impact they can have on companies, derivative suits are likely to quickly follow data-breach announcements in the future.

> **"The Dodd-Frank Wall Street Reform and Consumer Protection Act spawned a third new category of shareholder derivative cases: those involving allegedly excessive executive compensation.**

While several such cases have been filed in recent years, to date, the only shareholder derivative case arising out of a data breach that led to an opinion on the merits involved Wyndham Worldwide Corporation, a global hotel and resort operator. When hackers breached Wyndham's computer network several times between 2008 and 2010, stealing customers' financial data, two Wyndham shareholders sent letters to Wyndham's board demanding that Wyndham bring a lawsuit based on the data breaches against certain officers and directors. The board, through its audit committee, hired counsel, investigated the claims and ultimately determined not to pursue them. Undeterred, the plaintiffs brought a lawsuit, *Palkon v. Holmes*, 2014 U.S. Dist. LEXIS 148799 (D.N.J. Oct. 20, 2014), alleging that the Board's rejection of their demand was wrongful.

Applying Delaware law (as Wyndham was incorporated in Delaware), the United States District Court for the District of New Jersey granted Wyndham's motion to dismiss. It reasoned that, under the business-judgment rule, Wyndham was entitled to refuse the plaintiffs' demand unless there were specific facts raising a reasonable doubt that the board acted in (1) good faith (2) based upon a reasonable investigation.

Given the increasing incidence of data breaches in today's world of electronic information, one can only expect more of these lawsuits in the future. Faced with these cases, corporations should continue to avail themselves of the time-tested responses. We address those options in Part II, next week.

ABCs of shareholder derivative litigation: Part II

Last week, we introduced the ABCs of shareholder derivative litigation: four new categories of derivative claims trending upward in many states, including Minnesota. They are (in ABC form): **A**ccounting restatements, **B**ribery allegations, **C**ompensation for executives, and **D**ata breaches.

In responding to these types of derivative claims, corporate entities have often availed themselves of time-tested procedural and substantive arguments. The three most common can be easily remembered by the successor mnemonic "DEF": the **D**emand requirement, **E**xculpation provisions, and **F**orming a Special Litigation Committee.

D. Demand/demand futility

A shareholder seeking to bring a derivative lawsuit must first satisfy the demand requirement. The demand requirement, which is codified in both federal and state rules of civil procedure, preserves the board's power to decide in the first instance whether to pursue litigation on behalf of the corporation—whether such litigation be against third parties, the company's officers, or even members of the board. As the Delaware Supreme Court explained in the seminal case *Aronson v. Lewis*, the demand requirement is a form of "alternate dispute resolution" that "exists at the threshold, first to insure that a stockholder exhausts his intracorporate remedies, and then to provide a safeguard against strike suits."

A shareholder can satisfy the demand requirement in either of two ways: (1) by serving a written demand that the board take particular action, or (2) by alleging particular facts demonstrating that making such a demand would be futile. Regardless of which approach the shareholder chooses, the demand requirement can be an effective defense against derivative actions—and at an early stage of the litigation, before significant costs are incurred.

1. Where demand is made

Where demand is made, the board can accept the demand and bring suit itself, or it can refuse the demand. The shareholder can only proceed with a derivative action if the board refuses the demand and that refusal is itself a breach of fiduciary duty. Because of the business judgment rule, which requires that courts defer to the decisions of boards on most governance issues, the burden is on the shareholder to plead facts raising a reasonable doubt that the board acted (1) in good faith, or (2) based on a reasonable investigation.

In recent derivative actions of the sort discussed last week, the key to a successful refusal of a demand has been conducting a thorough investigation of the alleged wrongdoing. *Palkon*, the Wyndham data breach case, provides an example. There, the Wyndham board refused the shareholder's demand based on its ongoing review of the data breach, including investigation by its audit committee and outside counsel. The court rejected the shareholder's allegations.

In contrast, *Rich ex rel Fuqi International* is a lesson in what not to do. After receiving the shareholder's demand, the Fuqi board launched investigations by its audit committee and a newly formed special internal investigation committee, but failed to respond to the shareholder for two years. In the meantime, neither committee did much investigating, and the Fuqi management failed to pay the audit committee's legal counsel, forensic specialists and auditor, which stopped the committee's work and led to resignations from the board and both committees. Not surprisingly, the court concluded that the shareholder had raised at least a reasonable doubt that the board acted in good faith, and allowed the shareholder to proceed with a derivative action.

2. Where demand is not made

Where a shareholder opts not to make a demand on the board, it must sufficiently allege that doing so would have been futile. Delaware courts have crafted two tests for determining demand futility which are followed in many, though not all, jurisdictions. The *Aronson* test applies where the shareholder's underlying allegation involves a conscious business decision; it requires the shareholder to allege facts creating reasonable doubt that (1) the directors are disinterested and independent, or (2) the challenged transaction was otherwise the product of a valid exercise of business judgment. The *Rales* test applies where the shareholder's underlying allegation involves a failure of oversight; it requires the plaintiff to allege facts creating a reasonable doubt that the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand. In Minnesota, demand is futile only where, as the Minnesota Supreme Court stated in *Winter v. Farmers Educ. & Coop. Union*, it is "plain from the circumstances that it would be futile."

In the cases discussed last week, demand futility often turned on whether at least half the directors on the board were disinterested. Shareholders struggle to overcome the demand futility hurdle where the board is exculpated from liability for certain conduct (covered in the next section) or is not deriving personal financial benefit from the underlying decision.

However, shareholders have successfully pleaded demand futility in cases where the directors knowingly breached their fiduciary duties or had a financial stake in the underlying decision.

Whether a corporation has received a demand or is challenging demand futility, the demand requirement can be an effective defense if the board has and continues to follow proper procedures. But the board can put itself in a better position to challenge demand futility by asking shareholders to adopt an exculpatory clause.

E. Exculpation

Exculpatory clauses minimize the scope of a director's potential personal liability for conduct in connection with their work on the board. Minnesota Statute 302A.251 Subd. 4 and Delaware General Corporation Law §102(b)(7), as two examples, authorize shareholders to adopt a clause in the corporation's charter eliminating a director's personal monetary liability for breach of the duty of care, but not for breaches of the duty of loyalty or actions or omissions not in good faith or that involve intentional misconduct or a knowing violation of law. Many other states have similar statutes authorizing exculpatory clauses.

In addition to protecting individual directors from ultimate liability for conduct akin to negligence, exculpatory clauses raise the bar a shareholder must clear to establish demand futility in a derivative action. As one court explained, where directors are protected by an exculpatory clause, "a plaintiff must plead particularized facts that demonstrate the directors acted with scienter, meaning they had actual or constructive knowledge that their conduct was legally improper." The court found that the shareholder's pleadings fell short in that case, because although the shareholder alleged that nine directors knew about bribery, the shareholder pleaded no particularized facts to support that allegation.

Together, the demand requirement and an exculpatory clause can provide a strong defense to shareholder derivative actions. When those mechanisms fail, however, a corporation can attempt to regain control of the litigation through a special litigation committee (SLC)

F. Forming a Special Litigation Committee

A special litigation committee (SLC) is an independent, disinterested body empowered by the board to decide whether, and in what manner, a derivative suit should proceed. The Delaware Supreme Court first authorized SLCs as a tool for managing derivative litigation in the landmark case *Zapata Corp. v. Maldonado*. Other states, including Minnesota, have followed suit. SLCs are an attractive option because a board that has a potentially conflicted majority may be able to appoint a small group of directors or outsiders who are independent, thereby giving the corporation another chance to show it can evaluate the shareholder's allegation fairly. And forming an SLC has the added benefit of allowing the derivative action to be stayed.

In Minnesota, showing that demand would be futile is far more difficult than under Delaware law because of a unique statutory provision, Section 302A.241 of the Minnesota Business Corporations Act (MBCA). That provision expressly permits the board of directors of a Minnesota corporation to refer a shareholder demand to a special litigation committee to "consider legal rights or remedies of the corporation and whether those rights and remedies should be pursued." Minn. Stat. §302A.241, subd. 1. The special litigation committee (1) may consist of "one or more independent directors or other independent persons," (2) can make a binding determination as to whether the corporation's rights or remedies should be pursued, and (3) is not subject to the board of directors' direction or control, but acts independently on behalf of the corporation. Minnesota is unique in allowing a SLC to consist of non-board members, and Minnesota courts often defer to the SLC's recommendation if (1) the members of the SLC possessed a disinterested independence and (2) the SLC's investigative procedures and methodologies are adequate, appropriate, and pursued in good faith.

The constant stream of derivative actions creates so much case law that it can be difficult to keep up with shareholders' latest theories. But whatever those theories are, a well-founded defense will begin with a consideration of DEF—Demand, Exculpatory Clause, Forming a Special Litigation Committee.

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