Navigating Derivative Claim Litigation

Insights from Leading Specialists

November 8, 2023

Seyfarth Shaw LLP

"Seyfarth" refers to Seyfarth Shaw LLP (an Illinois limited liability partnership).
©2023 Seyfarth Shaw LLP. All rights reserved. Private and Confidential

Legal Disclaimer

This presentation has been prepared by Seyfarth Shaw LLP for informational purposes only. The material discussed during this webinar should not be construed as legal advice or a legal opinion on any specific facts or circumstances. The content is intended for general information purposes only, and you are urged to consult a lawyer concerning your own situation and any specific legal questions you may have.

©2023 Seyfarth Shaw LLP. All rights reserved. Private and Confidential

Speakers

Greg Markel
(Moderator)
Partner
Seyfarth Shaw

Andrew Escobar
Partner
Seyfarth Shaw

Sarah Fedner
Associate
Seyfarth Shaw

John Favilla
AVP of Claims
Berkley Pro

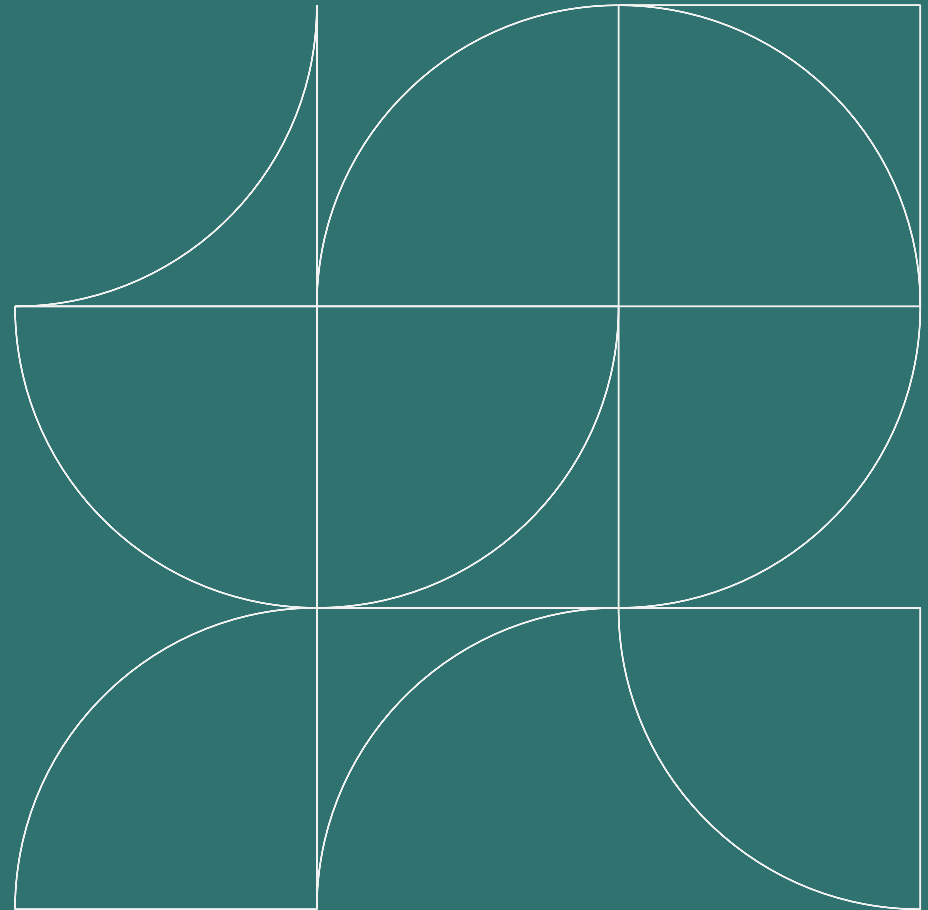
©2023 Seyfarth Shaw LLP. All rights reserved. Private and Confidential

Agenda

01	Introduction: Prerequisites and Key Considerations for Filing Derivative Claims
02	The Roles and Responsibilities of Corporate Boards and Senior Officers
03	Navigating the Nuances of Demand Requirements
04	Effective Strategies for Addressing Demand Futility
05	Crafting Thorough Responses to Demands
06	What Happens After Demand Refusal
07	Recognizing the Vital Importance of Early Factual Review and Discovery
08	Damages

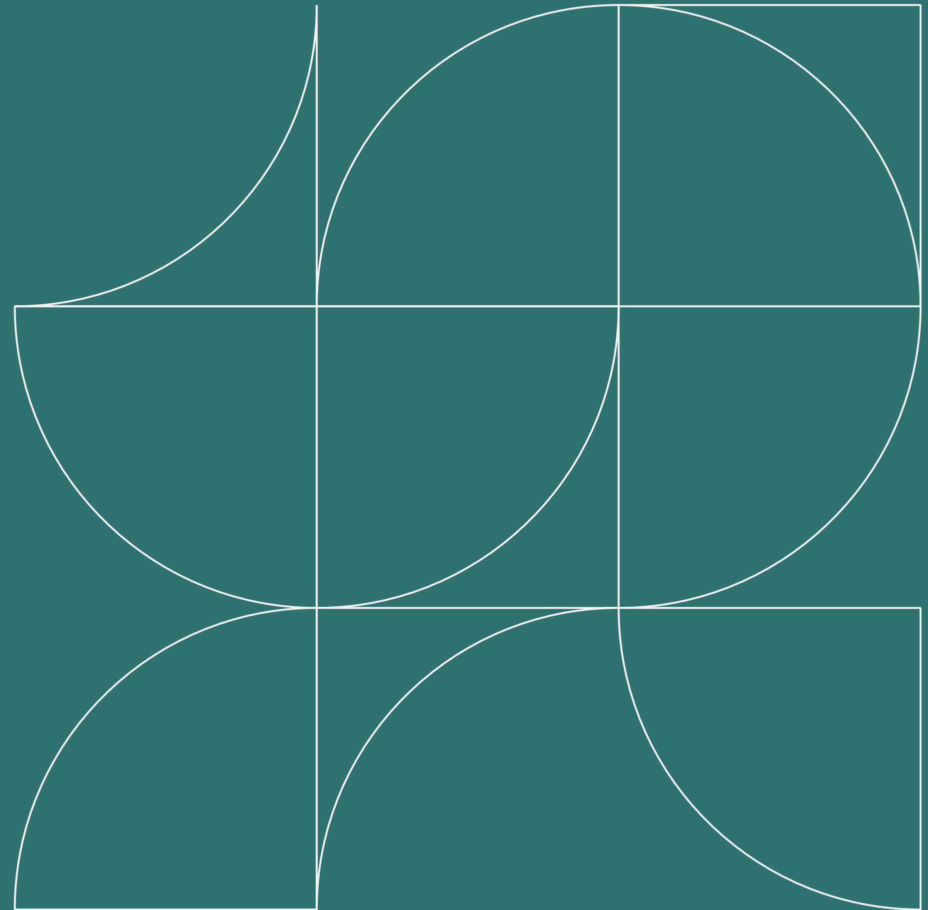
©2023 Seyfarth Shaw LLP. All rights reserved. Private and Confidential

Prerequisites and Key Considerations for Filing Derivative Claims



©2023 Seyfarth Shaw LLP. All rights reserved. Private and Confidential

The Roles and Responsibilities of Corporate Boards and Senior Officers



©2023 Seyfarth Shaw LLP. All rights reserved. Private and Confidential

Directors’ Role

The Board of Directors has broad discretion to make decisions for and act on behalf of a corporation.

- **Derivative Actions:**
  - Authority for initiating a derivative action lies with the board of directors.
  - The board decides whether to file a claim on behalf of the corporation for damages or wrongdoing.
  - Claim Validity: Damages or harm must be related to the interests of the corporation for a derivative claim to be valid.
- **Decision-Making:**
  - Ultimate decision-making authority, including initiating litigation, generally rests with the board.
  - Exceptions: When a majority of the board lacks independence or has conflicts of interest.
- **Delegation of Authority:**
  - Allowed if reasonable, usually through a board resolution.
  - Defined and approved by a majority of independent board members in good faith.
- **Protection of Decisions:**
  - Independent directors and special committees' decisions are protected by the business judgment rule.
  - Conditions: Consistency with fiduciary duties, absence of conflicts of interest, and acting reasonably and in good faith.
- **Common Claims:**
  - Claims against corporate directors and officers often involve breaches of duty, loyalty, oversight, and waste of corporate assets.

©2023 Seyfarth Shaw LLP. All rights reserved. Private and Confidential

Duties of Officers

- Fiduciary duties of officers of a corporation are similar those of the board of directors but the breadth of the obligations are less wide and in some cases much less stringent than those that apply to the board.
- Clearly officers are expected to carry out the duties entailed in their employment and there is a great deal officers are expected to do and not to do. Of most relevance in this description of corporate governance obligations are the previously described instances where a board delegates responsibilities to an officer or officers
- Clearly, officers are expected to carry out any such duties with care and loyalty to the corporation. Self-dealing and letting personal interests outweigh the interests of the corporation will expose officers to liability for breach of the duty of loyalty.
- Negligence with respect to duties assigned to an officer is a breach of the duties of care and loyalty and possibly, depending on the circumstances' the duty of oversight.
- Recently, there has been an increase in cases filed by shareholder plaintiffs as derivative claims against individual officers who fail to carry out their duties with care and loyalty to the corporation's interests.

D&Os' Fiduciary Duties to Corporation and Shareholders

Duty of Care

Duty of Loyalty

Duty to Disclose/Candor

Duty of Oversight

©2023 Seyfarth Shaw LLP. All rights reserved. Private and Confidential

- **Duty of Care**

  Directors must act in good faith and with care to set up systems of information flow in order to be reasonably informed in taking actions necessary to make informed, thoughtful and educated decisions on behalf of the corporation.

- **Duty of Loyalty**

  Directors must act in the best interest of the corporation and its shareholders. Corporate interests should take precedence over any personal interest of a director, officer or controlling shareholder .

- **Duty to Disclose/Candor**

  When the board decides to ask shareholders to vote on an issue or a vote is required, directors must stay informed on efforts to fully disclose all material and relevant information within their knowledge after reasonable inquiry.

- **Duty of Oversight**

  The duty of oversight has been the subject of a number of cases recently, which apply to oversight by both directors and officers. With respect to directors, the Marchand case has clarified the duty of oversight to include establishing reasonable information flow systems to assess the adequacy of directors meeting their obligations to be informed on a regular basis about material issues and risks within the corporation. Recently cases have also confirmed that officers have similar obligations.

©2023 Seyfarth Shaw LLP. All rights reserved. Private and Confidential

Subject to exceptions relating to lack of independence, conflicts of interest or delegation of responsibility to others, Directors are responsible for:

- Making all major decisions on behalf of the corporation which have not been properly delegated to management or a committee
- Seeing to it that the company has set up reasonable compliance and risk oversight systems that give regular reports to the board, particularly where the information involved is important for the board and officers to be knowledgeable about, in order to properly meet their respective duties and obligations. Such systems should be set up with reasonable care and with a reasonable expectation on the part of the directors that the system will be adequate to keep board members and some officers, reasonably informed.
- Determining overall business goals and objectives.
- Overseeing utilization of resources and budgeting expenses.
- Overseeing management of the business and deciding who will manage its daily operations.
- Under the emerging law of oversight duties of directors', it is important for directors and officers to be alert to identify and address promptly and with care significant risks to the corporation and its shareholders and other stakeholders, employees, its business, and its reputation and brand).
- Often derivative cases allege that directors failed to live up to their responsibilities or breach fiduciary duty.

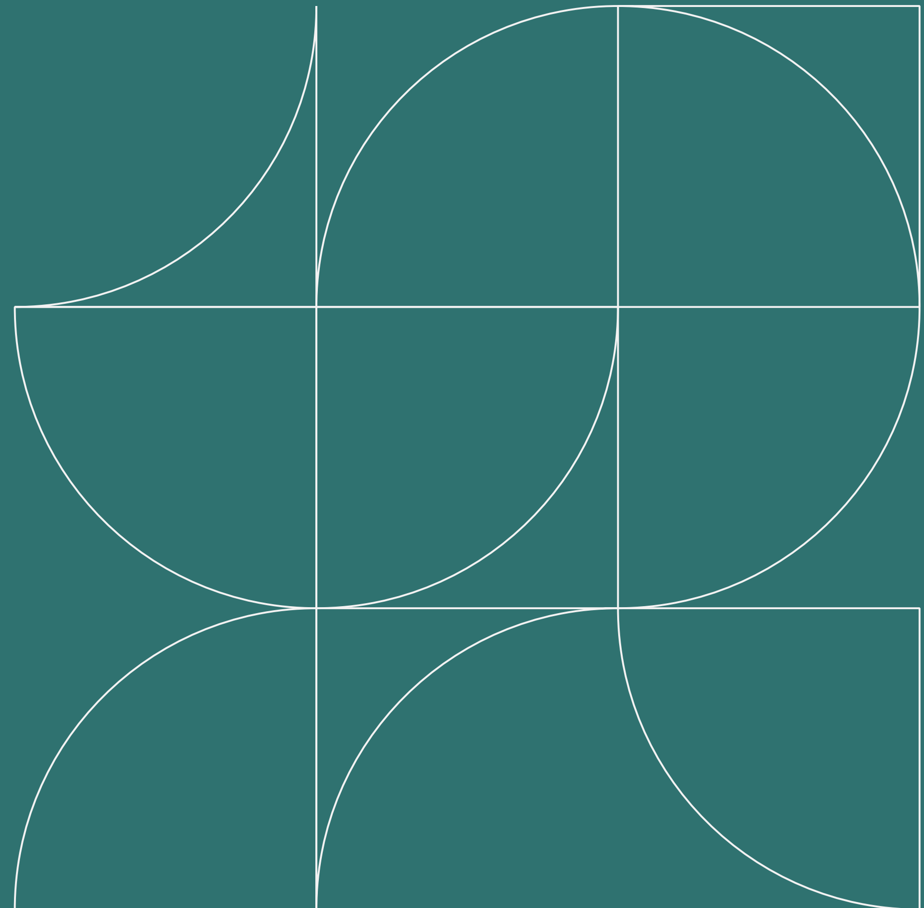
©2023 Seyfarth Shaw LLP. All rights reserved. Private and Confidential

The Business Judgment Rule

- The business judgment rule is a legal presumption that protects corporate directors and officers who have no personal interest in the outcome of specific board issues or actions, and who, while reasonably informed, act in good faith and with an honest belief that they are taking the action with the lawful and legitimate interests of the corporation and shareholders in mind. Directors and officers who meet these criteria, will normally have protection from liability for breaches of fiduciary duty relating to such issues or actions.
- This doctrine is a common law rule which is based in part on the concept that courts are ill-equipped and infrequently called upon to make business judgments on how corporations should be run or managed. Judges generally recognize that officers of corporations are more familiar with and better informed of what is best for the operation of the business than judges.
- Courts will accordingly afford great deference to board actions taken by independent directors and non-conflicted directors who are reasonably informed on the issue in question and act in good faith in accordance with duties of care, loyalty, and oversight.
- The business judgment rule presumption is rebuttable and may be rebutted by evidence that the directors breached a fiduciary duty by engaging in self-dealing, making decisions tainted by conflicts of interests, or acting fraudulently, dishonestly, or in bad faith, or failing to act with reasonable diligence in informing herself of relevant facts and circumstances.

©2023 Seyfarth Shaw LLP. All rights reserved. Private and Confidential

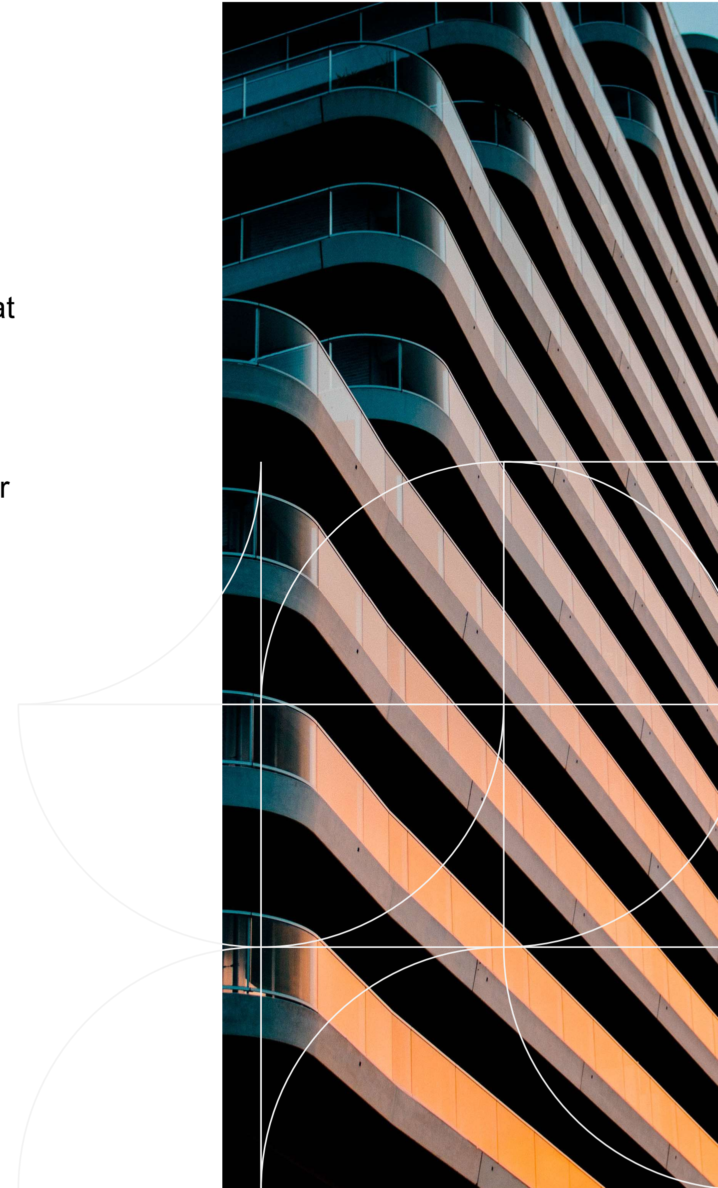
Navigating the Nuances of Demand Requirements



©2023 Seyfarth Shaw LLP. All rights reserved. Private and Confidential

The Demand Requirement

- In order for a shareholder to have standing to commence a shareholder derivative action, a shareholder must make a demand upon the corporation's board of directors asking the board to pursue the claim. This demand requirement may be excused, however, upon a showing that demand would be futile.
- The laws of Delaware, New York and many other states require that the complaint set forth with particularity the efforts of the plaintiff to secure the initiation of such action by the board or the reasons for not making such an effort.
- Although corporate law provides individual shareholders with recourse when they are treated unfairly by the board or overruled by the majority of the shareholders, minority shareholders are not empowered unilaterally to effect changes in corporate policy.
- Where individual shareholders seek to take control from the board of the decision on whether to commence litigation, they are required to meet the demand requirement that they demand the board bring the claim.
- That requirement reflects the basic principle of corporate governance that the decisions of a corporation--including the decision to initiate litigation--should be made by the board of directors or the majority of shareholders.



Internal Affairs Doctrine

This doctrine is the law of many states including Delaware and New York.

- Pursuant to the doctrine, “claims concerning the relationship between the corporation, its directors, and a shareholder,” such as shareholder derivative actions, “are governed by the substantive law of the state or country of incorporation.”
- Where the corporation is a foreign corporation, the law that governs is the law of the country of incorporation.
- The basic reasoning behind the Internal Affairs Doctrine is that, by choosing to incorporate in a particular state, the shareholders of a corporation have made a choice, for their own reasons and considerations, as to what law will govern the internal affairs of the corporation and the conduct of its directors, officers and shareholders.
- Having made that choice, a corporation and its directors, officers and shareholders have a right and reasonable expectation that the laws of such state will be applied to any derivative action or other internal affairs dispute that may arise.
- Federal diversity jurisdiction also requires that the amount in controversy exceed $75,000. In determining whether the suit meets the amount in controversy requirement, courts examine the amount at stake for the corporation, rather than for its individual shareholders. Because the shareholders in a derivative suit enforce rights that belong to the corporation, the amount of each individual shareholder's interest is irrelevant.

©2023 Seyfarth Shaw LLP. All rights reserved. Private and Confidential

The Contemporaneous Ownership Rule

In addition to a demand, under New York law and the law of many other states, only complainants who were shareholders at the time of the filing of the action and at the time of the challenged transaction have standing to bring a derivative action.

- An action may be brought in the right of a domestic or foreign corporation to procure a judgment in its favor, by a holder of shares or of voting trust certificates of the corporation or of a beneficial interest in such shares or certificates.

APPLYING THIS STATUTE

- Some courts have held that the shareholder does not need to be a stockholder of record; it is sufficient if he or she is the equitable owner of the stock.
- Thus, for example, a trustee of a trust holding stock in a corporation is entitled to institute a shareholder derivative action against that corporation unless otherwise disqualified. Importantly, the percentage interest or the value of the plaintiff's holdings of stock is irrelevant to the right of action.
- The policy underlying the requirement of ownership of stock at the time of the alleged wrongdoing and at the time of the transaction under the "contemporaneous-ownership" rule, is twofold:

1) to prevent potential derivative plaintiffs from 'buying a lawsuit' by purchasing stock; and
2) to ensure that derivative actions are brought by shareholders who have suffered injury and have an interest in the outcome of the case." Because the contemporaneous ownership rule seeks to foster public policy by discouraging speculation in litigation, it is usually rigorously enforced.

- Some courts, however, have recognized a limited exception to the contemporaneous ownership rule where the plaintiff alleges a continuous wrong. Under the "continuous wrong" theory, a plaintiff can challenge a corporate action that occurred before he or she became a shareholder if that action was part of a continuing fraud or impropriety that had begun but had not concluded at the time the plaintiff became a shareholder.
- In determining whether a wrong complained of is a continuous one, courts examine when the specific acts of the alleged wrongdoing occurred, not when their effect was felt.

The requirement that ownership continue until commencement of the derivative action is rooted in practical considerations. Although in a theoretical sense a derivative action is brought for the benefit of the corporation, in order to avoid plaintiffs who are not engaged in achieving a benefit for the corporation plaintiff-shareholder should have some interest in the recovery by the corporation. In many states, where the shareholder voluntarily disposes of the stock or loses title to his stock, his rights as a shareholder cease, and his interest in the litigation is also lost.

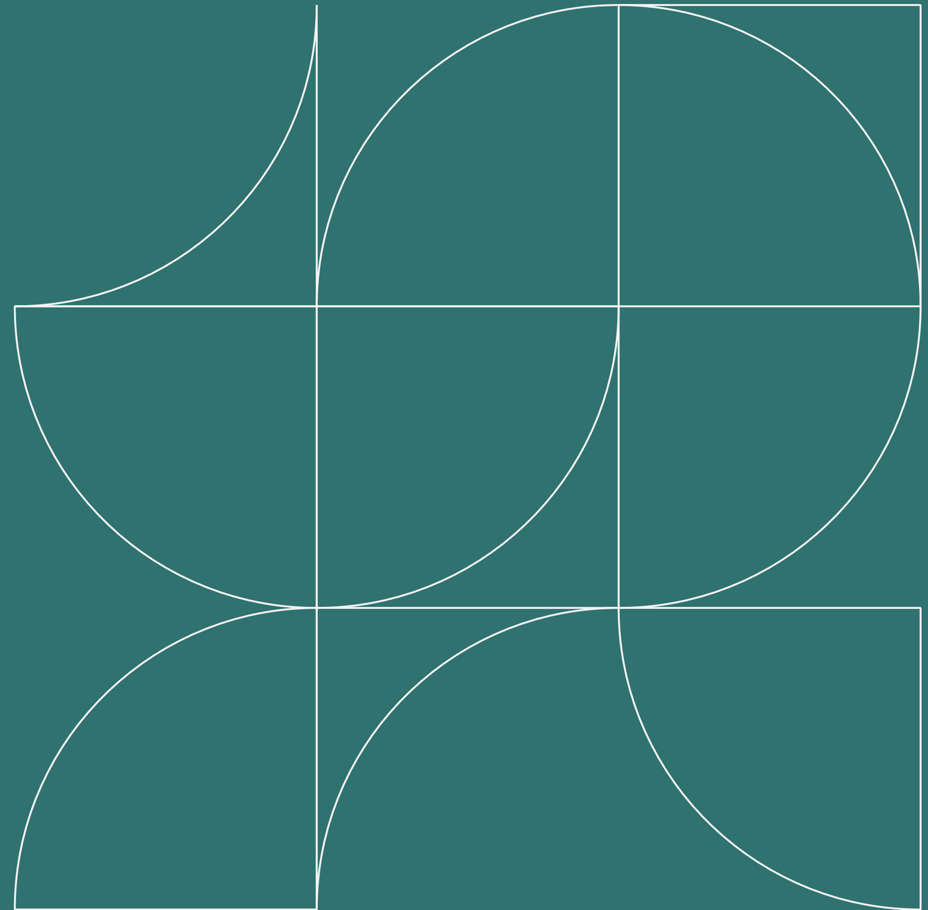
©2023 Seyfarth Shaw LLP. All rights reserved. Private and Confidential

Investigation and Discovery

Before making a demand, plaintiff's counsel should make as thorough as reasonably possible a review of public sources for factual information by searching through all available public and private information, "including media reports, internet information, relevant corporate filings, and when permitted … counsel should interview persons with knowledge of the allegations." Depending on the state, shareholders may have both a common-law right to inspect the corporation's minutes and certain other corporate documents.

©2023 Seyfarth Shaw LLP. All rights reserved. Private and Confidential

Effective Strategies for Addressing Demand Futility



©2023 Seyfarth Shaw LLP. All rights reserved. Private and Confidential

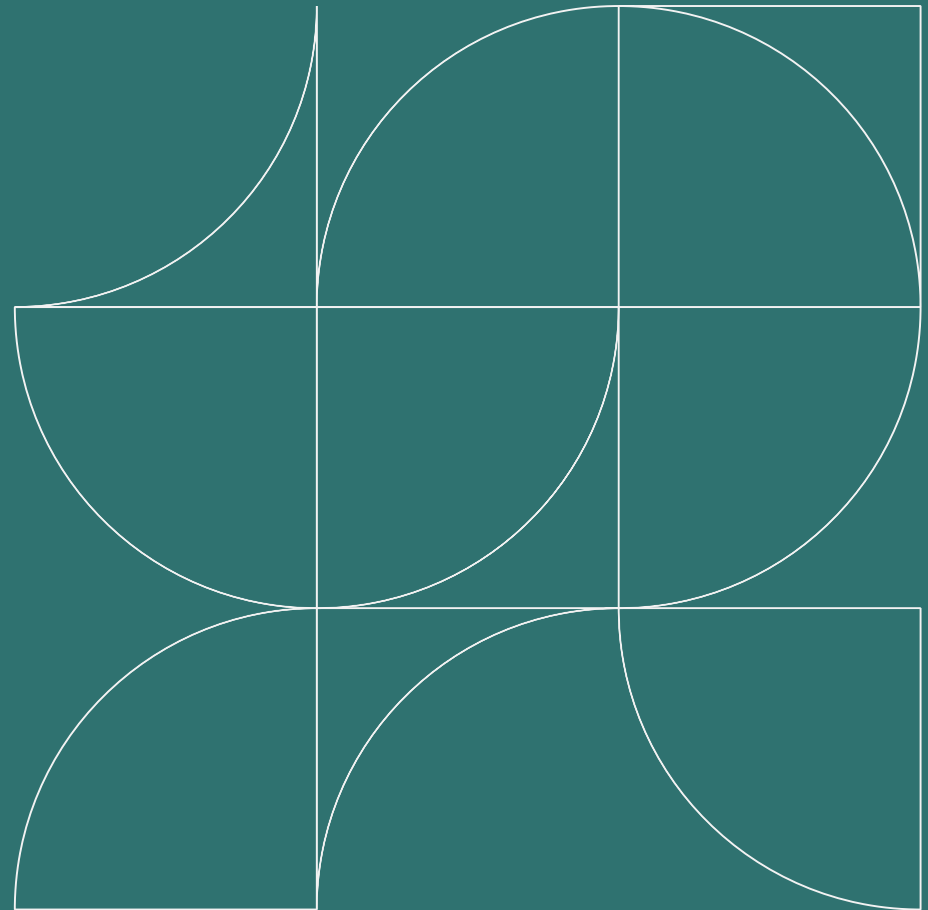
The Demand Futility Standard and Considerations Relating to It

This standard is the law in most states and is subject to particularized pleading.

- Most states follow Delaware’s pronouncement of the standard for establishing demand futility
- Particularized pleading is required under most jurisdictions’ rules
- Must be done on a director-by-director basis based on the board composition at the time of the lawsuit
- Demand will be excused if any of the following prongs is true for at least half of the board:
  - (1) The director received a material personal benefit from the alleged misconduct
  - (2) The director would face a substantial likelihood of liability on the claims that are the subject of the demand, or
  - (3) The director lacks independence from the person accused of misconduct

©2023 Seyfarth Shaw LLP. All rights reserved. Private and Confidential

Crafting Thorough Responses to Demands



©2023 Seyfarth Shaw LLP. All rights reserved. Private and Confidential

Making a Proper Demand

- Demand should generally be made on the board of directors. Communications to other parties, e.g., corporate officers, shareholders, or attorneys, may not be considered effective. Not all states provide any specific instruction for making demand and courts have held that the "[d]emand to sue need not assume a particular form nor need it be made in any special language."
- At the same time, courts require that the demand be made in "earnest, not a simulated effort. ...". A demand that simply recites "well-publicized business setbacks and problems ... without indicating with any specificity the causes of action available to the corporation or those persons potentially liable," will not likely be considered adequate.
- Although demand may be made orally, it is best to make the demand in writing and it is common to do so. As a practical matter, it should be addressed to the board of directors as a group, to the chairman of the board, or to the board through the chairman, and sent to the corporation's principal place of business. The demand letter should:
  1. identify the alleged wrongdoers;
  2. describe the factual basis of the allegations of wrongdoing and the harm caused to the corporation;
  3. request that the directors bring suit against those culpable;
  4. provide the directors with sufficient time to consider and act upon the demand; and
  5. indicate if it is the case that litigation will result from an improper refusal to sue.
  6. the allegations set forth in the demand letter should be detailed, not conclusory.
  7. moreover, while certainly not required, a draft of a complaint delivered to the directors can sometimes also be helpful in demonstrating that the demand is made with particularity and clearly and directly informs the directors of the plaintiff-shareholder's claims and intentions. It may in some cases open up channels of negotiation between interested parties.
- Because the judiciary prefers that the shareholder and the corporation resolve the claims on their own, it is expected that following demand, the shareholder "must make reasonable efforts to assist the corporation" in investigating the claims.

©2023 Seyfarth Shaw LLP. All rights reserved. Private and Confidential

Shareholder Litigation Dynamics

Waiver of right to claim futility

In some states, including Delaware, as soon as the plaintiff-shareholder makes demand upon the board, he or she effects a waiver of the right to claim demand futility in the future in the case and moots any such arguments made in the case in the past. Practitioners should carefully consider the pros and cons of serving a demand upon the board.

The Corporation's Response to a Demand

Once the board of directors is apprised of a demand, its role is to determine the course of conduct that is in the best interests of the corporation. While the directors are under no obligation to go forward with litigation, they do have a fiduciary duty to consider carefully, and often investigate, the claims raised by a shareholder and any corporate interests that will likely be affected by a lawsuit. With that in mind, the shareholder should allow the directors a reasonable amount of time to complete their analysis of the claims and decide upon a course of action.

Board Committees

Where appropriate on conflict and independence grounds, the board may delegate authority to conduct the inquiry to an existing committee or a special litigation committee composed of independent board members. There are two types of delegations: (i) a delegation to investigate and report back to the board with a recommendation for further action and (ii) authority to decide on the issue in question including whether to prosecute a lawsuit.

©2023 Seyfarth Shaw LLP. All rights reserved. Private and Confidential

The Role of Counsel to a Board Committee

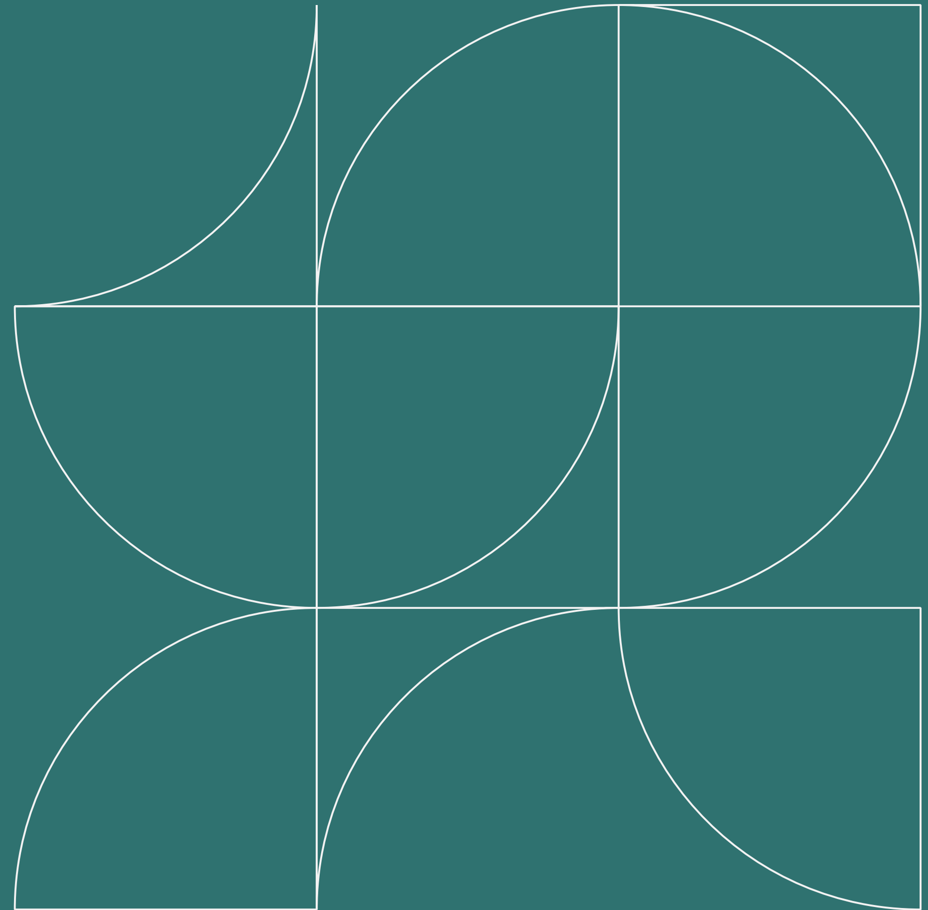
- Generally, a committee will retain outside counsel who are not closely tied to the corporation or the board members and is not conflicted, to advise it on best practices for board committees, how to maintain the committee's independence, avoid conflicts of interest and corporate governance principles.
- Committee counsel should explain fiduciary duties, fiduciary duties of care, loyalty and oversight
- Committee counsel should also explain to the committee how best to avoid waiver of privilege.

From the time the demand is made, the corporation's counsel should advise the board of its responsibilities to:

1. Determine the extent of the directors' and officers' insurance coverage for the claim, whether an insurance carrier should be notified.
2. Consider whether delegation to a committee is in the best interests of the corporation and whether directors and officers have interests sufficiently divergent from those of the corporation that they should retain separate counsel.
3. Corporate counsel, or committee counsel, should also communicate in writing with shareholder's counsel to inform them that the board of directors has been advised of the demand and, as many demand letters fail to provide necessary information, invite the shareholder to submit missing details regarding the allegedly improper behavior.
4. In some situations, the board may undertake the lawsuit and sue on the corporation's behalf. Often, however, the board will refuse demand, which is highly likely to lead to the filing of a derivative complaint by the plaintiff-shareholder.

©2023 Seyfarth Shaw LLP. All rights reserved. Private and Confidential

What Happens After Demand Refusal



©2023 Seyfarth Shaw LLP. All rights reserved. Private and Confidential

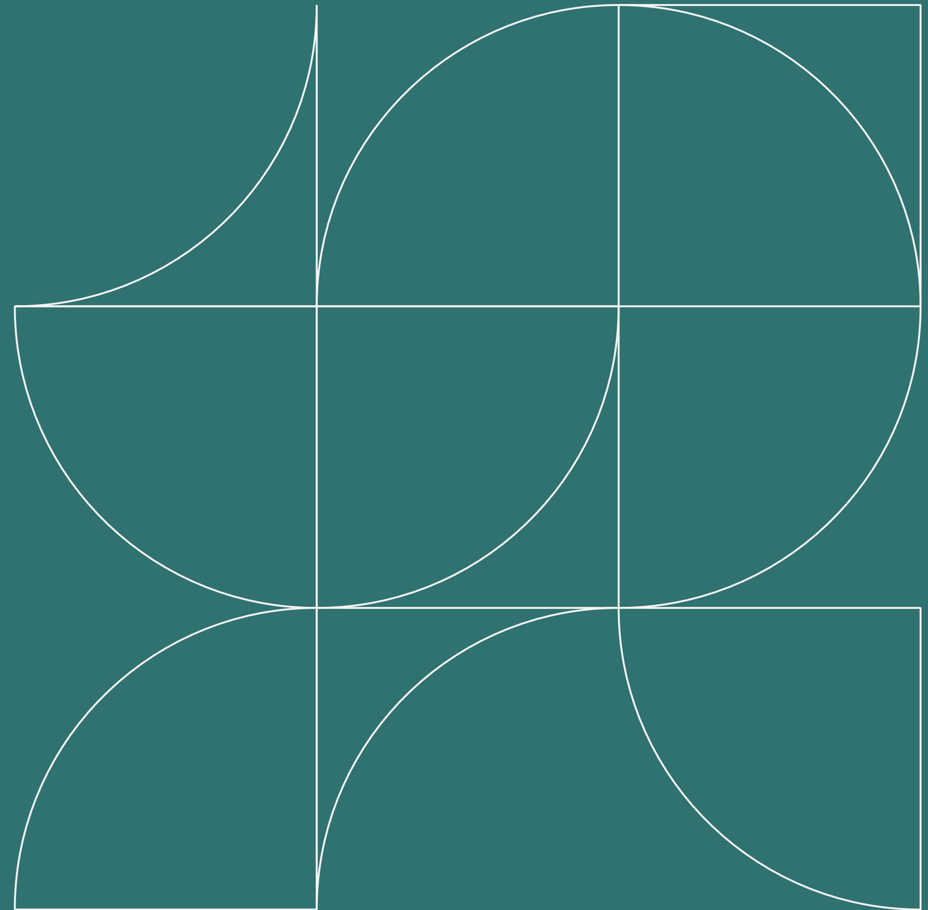
Demand Refusal

Once a board of directors refuses to initiate suit, a plaintiff-shareholder will likely file a derivative complaint for the benefit of the corporation often essentially repeating the allegations already made to the board.

- The corporation then may move to dismiss the complaint based on the board's business judgment that the suit is not in the best interests of the corporation.
- The shareholder may counter the motion to dismiss by arguing that refusal was wrongful or self-interested.
- While the demand requirement necessitates that a plaintiff plead with particularity that a demand was made or the specific reasons why no demand was made, there is no such pleading standard requiring allegations that the board wrongfully rejected the demand.
- If the refusal was issued by a special litigation committee, a shareholder can establish that the committee's refusal was wrongful if the shareholder can successfully challenge the independence of the members of the committee and the appropriateness of the investigative procedures chosen and pursued by the committee.
- However, courts are generally deferential to those to whom the business judgment rule applies.

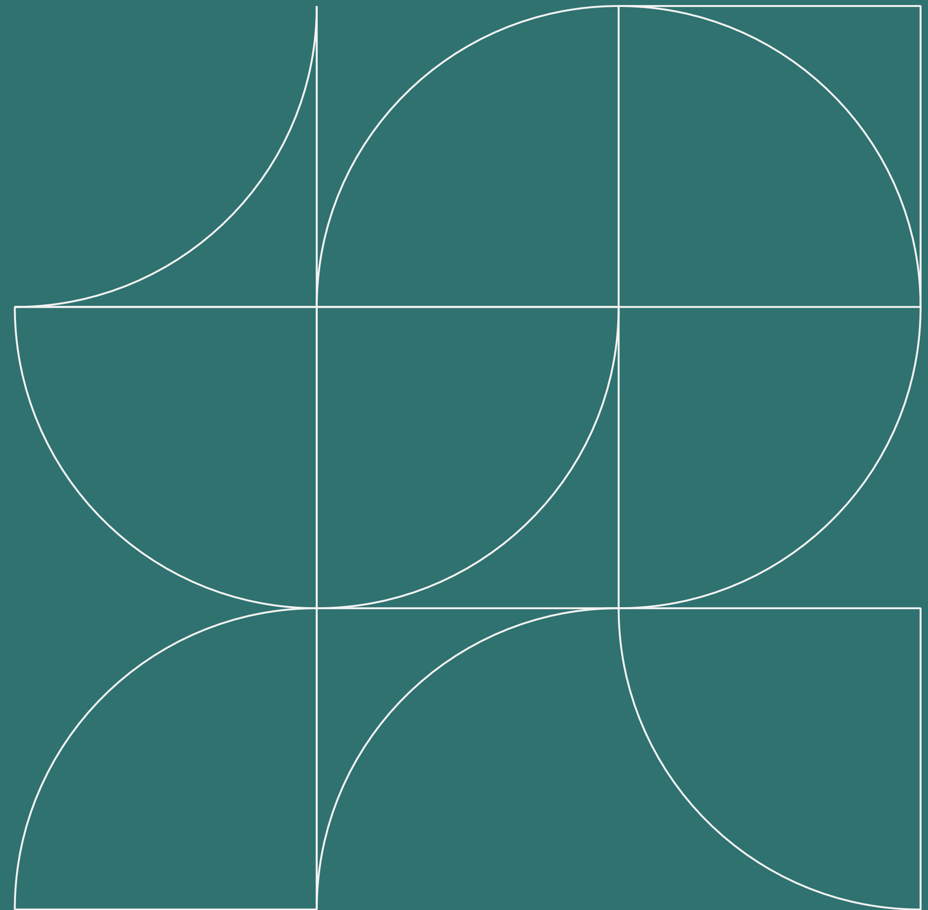
©2023 Seyfarth Shaw LLP. All rights reserved. Private and Confidential

Recognizing the Vital Importance of Early Factual Review and Discovery



©2023 Seyfarth Shaw LLP. All rights reserved. Private and Confidential

Damages



©2023 Seyfarth Shaw LLP. All rights reserved. Private and Confidential

Defense Costs Exposure

- §220 Demands
- Derivative Demand Investigations
- Litigation
  - Indemnifiable Loss

Resolution / Settlement

- Dismissals
- Therapeutics
- Settlements
  - Non-Indemnifiable Loss

Outcomes

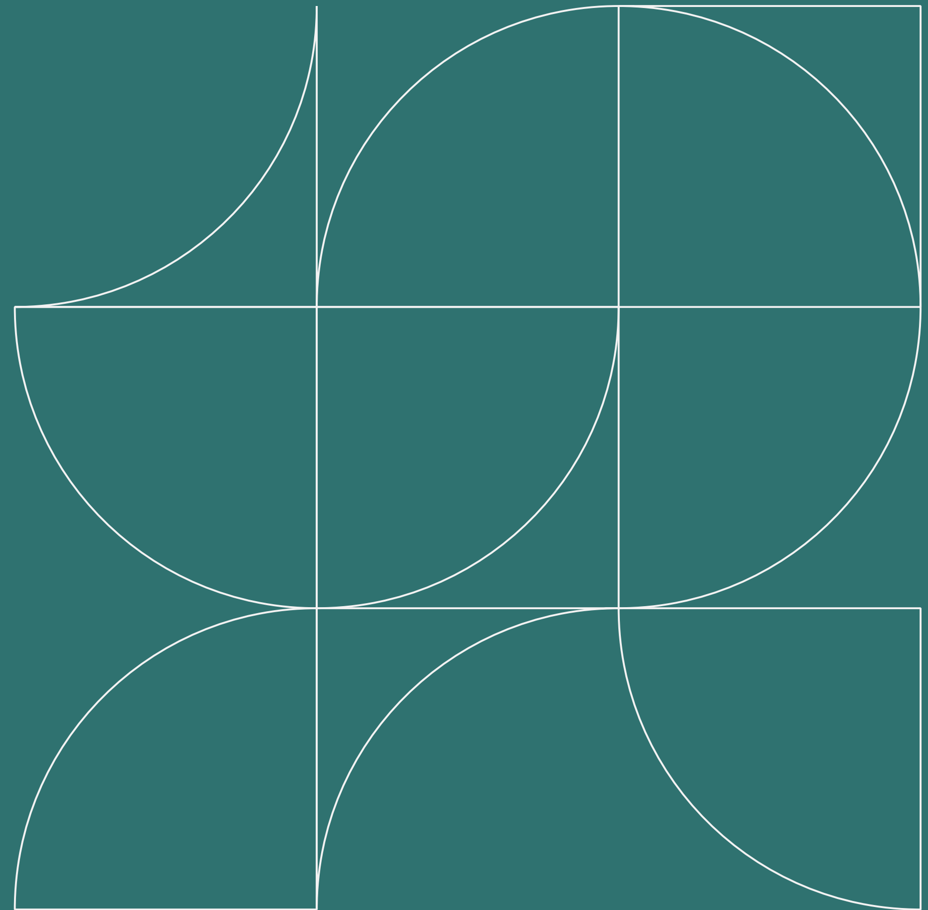
Partial List of Recent Derivative Settlements by Settlement Year

- Madison Square Garden Entertainment Corp. 2023: $85 million
- CBS/Viacom (Paramount Global) 2023: $167.5 million
- Cardinal Health, Inc. 2022: $124 million
- Goldman Sachs/1MBD 2022: $79.5 million
- Boeing 737 Max Air Crashes 2021: $237.5 million
- American Realty Capital Partners 2020: $286 million
- McKesson Corp. 2020: $175 million
- Wells Fargo Fictitious Account Derivative Suit 2019: $240 million
- 21st Century Fox 2017: $90 million
- PG&E 2017: $90 million
- Freeport-McMoRan 2015: $137.5 million

Identifying Potentially Large Cases

- No Mathematical Calculation Like 10(b)(5) Cases
- Subjectivity of Settlement Demands
- Five Areas of Concern that Could Lead to Large Settlements
  - Conflicts of Interest
  - Merger & Acquisition Diligence
  - Bad Behavior
  - Health and Safety
  - Fraud
- Governance and Oversight

Practical Takeaways



©2023 Seyfarth Shaw LLP. All rights reserved. Private and Confidential

Practical Takeaways for the Board

- **Engage Counsel:** The Board should make sure its existing counsel is familiar with derivative litigation. If not, it should retain new counsel for this assignment.
- **Assess Board Composition and Qualifications:** The board should periodically evaluate its composition and the corporate structure and charter of the company to determine whether there is sufficient experience and expertise and diversity on the board and an absence of conflicts and of domination by a conflicted controlling person to properly address the relevant issues facing a company. One of those issues would be a derivative demand. The duty of loyalty requires that directors always keep the best interests of the corporation as the primary goal when assessing options in decision-making.
- **Delegation of Authority:** The board should determine what topics or issues it should reasonably delegate to a special committee, to another committee of the board, or to management. In making these determinations, the board should consider the expertise of any likely candidate or candidates and, in particular, make sure of the absence of any conflict of interest and of any domination by a controlling party on the part of the candidate. Other factors to consider in selecting committee members include having sufficient time to devote to meet their duty of care, experience as a board or committee member, expertise on an issue and, importantly, having good judgment.

  The board should be sure its existing counsel is familiar with Derivative Litigation. If not, it should retain new counsel for this assignment.
- **Build Reporting Structures:** In order to comply with its duty of oversight, the board must arrange for an adequate information flow to that board. In doing so, the board must carefully consider what information it needs to properly oversee risks and mission critical business issues that the company faces, as well as how it will receive that information in time to make it useful in their decision-making process.
- **Create and Review Internal Controls:** The board should ensure that an adequate system of internal controls exists or should properly create such a system of controls. Sufficient internal monitoring of compliance with company policies and government laws and regulations should be in place. The board should perform assessments of these internal controls and regularly get the report of an expert on such controls and understand how the company performance compares with industry standards.
- **The Board and Stakeholders:** The board should understand significant company policies and procedures and understand how management is engaging the corporation's shareholders. They should keep in mind the corporate purpose adopted by the company. The board should also consider information flow to and treatment of other stakeholders such as employees, investors, customers, business partners, suppliers, the environment, the value of diversity and other factors.

©2023 Seyfarth Shaw LLP. All rights reserved. Private and Confidential

CLE CODE

Please note that CLE forms for this program must be submitted to CLE@Seyfarth.com within 10 business days of the program taking place.

©2023 Seyfarth Shaw LLP. All rights reserved. Private and Confidential

thank you

contact information

For more information, please contact our presenters, listed below.

Greg Markel

gmarkel@Seyfarth.com | +1-212-218-5579

Sarah Fedner

sfedner@seyfarth.com | +1-212-218-3503

Andrew Escobar

aescobar@seyfarth.com | +1-212-218-3503

John Favilla

jfavilla@berkleypro.com | +1-212-618-2926

©2023 Seyfarth Shaw LLP. All rights reserved. Private and Confidential