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Courses of Action after Allegations of Misconduct

By Frederick H. Riesmeyer II, Kendra D. Hanson, Andrew M. Zeitlin, and Alison P. Baker

You represent a corporation when one member of the four-person board of directors comes to you with a new lawsuit filed against all four directors by a minority shareholder, alleging breach of fiduciary duty, fraud, and/or another business tort. The board asks you to put together a plan for handling the derivative action and to outline strategies available to the board. Where do you start? What are your options?

This article examines the options available to a board when confronted with derivative actions, the duties and responsibilities of the board in responding to such actions, and how to determine a proper course of action.

Initial Considerations

A derivative action is any civil suit brought on behalf of a corporation to enforce a right that the corporation may properly assert but has failed to enforce. Fed. R. Civ. P. 23.1(a); Model Business Corporation Act § 7:40 (MBCA, adopted with slight adjustments by the majority of states). A derivative action has been described as "a justifiable, but limited intrusion upon the general authority of the directors to manage the business affairs of the corporation." *Boland v. Boland*, 31 A.3d 529, 548 (Md. 2011) (internal quotes omitted). The substantive claim itself belongs to the corporation. It is this unique characteristic of derivative actions—the corporation's ownership of the claim—that must drive the board's strategy on how to respond to a demand and/or derivative action.

> **Prerequisites to a derivative action.** Generally speaking, the prerequisites to bringing a derivative action are (1) the plaintiff must have standing; (2) the plaintiff must fairly and adequately represent the interests of the corporation; and (3) a written demand upon the corporation to take appropriate action may be required. MBCA § 7.41.
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> To establish standing, a plaintiff generally must have been a shareholder at the time of the alleged misconduct. Once a derivative plaintiff sells its stock, it no longer has standing to prosecute the derivative claims on behalf of the remaining shareholders. *Heckmann v. Ahmanson*, 168 Cal. App. 3d 119, 130 (1985). The standing requirements for appealing a dismissal or settlement in a derivative action are more stringent: A shareholder must be a named party, file a timely motion to intervene, or object to the subject dismissal or settlement. *In re UnitedHealth Grp. Inc. S'holder Derivative Litig.*, 631 F.3d 913, 916 (8th Cir. 2011).

Whether a named plaintiff will "fairly and adequately" represent the interest of the corporation and other shareholders depends on the facts and circumstances of each case. *Davis v. Comed, Inc.*, 619 F.2d 588, 593–94. Some factors courts have considered include the possibility that the plaintiff "may disregard the interests" of others (*Blum v. Morgan Guaranty Trust Co.*, 539 F.2d 1388 (5th Cir. 1976)); whether the plaintiff might use the derivative action to gain leverage (*Rothenberg v. Security Mgmt. Co., Inc.*, 667 F.2d 958, 960 (11th Cir. 1982)); indications that the plaintiff is not the true party in interest (*Nolen v. Shaw-Walker Co.*, 449 F.2d 506, 509 (6th Cir. 1971)); and the plaintiff's unfamiliarity with the litigation and unwillingness to learn about the suit (*Rothenberg*, 667 F.2d at 961). Where the plaintiff does not fairly and adequately represent the interests of the corporation and shareholders, the court will dismiss the derivative action.

The written demand requirement is intended to afford the corporation the opportunity to respond appropriately to allegations of misconduct. *Allison v. Gen. Motors Corp*., 604 F. Supp 1106, 1117 (D. Del. 1985). Accordingly, the demand should set forth those facts establishing the shareholder's right to bring the derivative action, advise the corporation as to the specific actions sought to be taken, and state the grounds for the actions. While the demand must be made on the corporation and not the board, it is the board that has the responsibility of reviewing and making the proper response to the demand.

While the MBCA, and many state statutes, require that a written demand must precede the filing of a complaint (MBCA § 7.4), the Federal Rules of Civil Procedure do not require a written demand. *See* Fed. R. Civ. P. 23.1. Therefore, the law of the particular jurisdiction should be carefully examined. *Compare Lewis v. Graves*, 701 F.2d 245 (2d Cir. 1983) (statutory requirement of written demand waived where demand would be futile), *with McCann v. McCann*, 138 Idaho 228, 236 (2002) (common law futility exception abrogated by statute). Failure to make a demand where one is required may serve as grounds for dismissing the action.

Responsibilities of the board of directors and investigating the demand. In response to a demand from a shareholder, the directors have the obligation to review the demand and conduct an appropriate investigation. Many statutes provide a limited period of time—often 90 days—for the board to respond appropriately and preclude the putative plaintiffs from commencing litigation immediately after service of the demand. MBCA § 7.42(2). However, there are exceptions to this rule. The plaintiffs may be permitted to commence litigation sooner if (1) the demand is rejected prior to the expiration of the statutory period, (2) a limitations period is about to expire, or (3) the corporation is at risk of irreparable harm if the full statutory period is allowed to run. *See, e.g., McCann v. McCann*, 138 Idaho 228, 235 (2002); *Albers v. Edelson Tech. Partners L.P.*, 201 Ariz. 47, 55 (Ct. App. 2001).

The board's investigation into the shareholder's demand must satisfy strict criteria. It must conduct a "reasonable inquiry" in "good faith" by "qualified" individuals. The

reasonable inquiry must be conducted by either a majority vote of qualified (usually, disinterested) directors; a majority vote of a committee (often referred to as a "special litigation committee," or an SLC); or, upon motion by the corporation, a court-appointed panel. An individual's status as a named defendant does not *per se* preclude him or her from being deemed a qualified director.

Whether the corporation's inquiry into the dissenting shareholder's allegations is reasonable is an issue of fact. *Madvig v. Gaither*, 461 F.Supp.2d 398, 407 (W.D.N.C. 2006) ("To be reasonable, the inquiry must be commensurate in scope with the nature of the issues raised by the complainant"). The determination of reasonableness will be based on the procedure followed, not the results of the procedure. *Johnson ex rel. MAII Holdings, Inc. v. Jackson Walker, LLP*, 247 S.W.3d 765, 773 (Tex. Ct. App. 2008) (attacking the conclusions that the directors reach upon review of relevant information is insufficient to attack the "reasonableness of the processes followed.").

Further, the inquiry must also be conducted in good faith. The MBCA defines good faith as "honestly or in an honest manner." MBCA §§ 8.30, 8.51; *see also Madvig v. Gaither*, 461 F.Supp.2d 398, 408 (W.D.N.C. 2006) (defining good faith as a decision made "honestly, conscientiously, fairly and with undivided loyalty to the corporation"); *Abella v. Univ. Leaf Tobacco Co.*, 546 F. Supp. 795, 800 (E.D. Va. 1982) (noting that a determination of good faith requires an "inquiry…into the spirit and sincerity with which the investigation was conducted"). A judicial assessment of good faith should not contravene the deference afforded by the business judgment rule; nevertheless, an investigation restricted in scope or execution or performed so halfheartedly as to "constitute a pretext or sham," will not be afforded deference. *Auerbach v. Bennett*, 47 N.Y.2d 619, 634–35 (N.Y. 1979).

Strategies for Responding to a Derivative Action or Demand

There are a number of strategies and options that a corporation should consider upon receiving either a shareholder demand or a Summons and Complaint.

Respond to a demand. Although a formal response to a demand is generally not required, a board should respond to all pre-suit demands absent a compelling reason to the contrary. Doing so demonstrates that the corporation has taken the demand seriously and that the board is exercising its appropriate authority. *Seidl v. Am. Century Companies, Inc.*, No. 2012 WL 7986873, at *5–7 (W.D. Mo. Oct. 31, 2012). The response to the demand may simply be a refusal to pursue further investigation of the alleged misconduct or refusal to pursue the anticipated litigation.

Assume control of litigation. If the board determines that the litigation has merit and is in the corporation's best interest to pursue, it may seek to assume control of the litigation, effectively taking over the claim from the plaintiff. One of the primary purposes of the demand requirement is to give the corporation the opportunity to take over the suit. *Elfenbein v. Gulf & W. Indus., Inc.*, 590 F.2d 445, 450 (2d Cir. 1978). This allows the

Board to maintain its control over the affairs of the corporation, and it takes advantage of the corporation's position to pursue this and other remedies, handle the expense of litigation, and terminate baseless litigation. *Lewis v. Graves*, 701 F.2d 245, 247, 248 (2d Cir. 1983). To take this action, a corporation generally must file a motion seeking to assume control of the litigation and/or to consolidate a corporation's suit with the pending derivative suit. If the derivative plaintiff opposes this action, the corporation must demonstrate that there was no collusion between the corporation and any defendants and that the corporation would prosecute the case in good faith. *In re Penn Cent. Sec. Litig.*, 335 F. Supp. 1026, 1040 (E.D. Pa. 1971).

Seek a stay of litigation. If a corporation is unsure of the merits of a derivative claim and/or how it intends to respond, it may seek time to make an appropriate assessment by requesting a stay of the litigation. Under MBCA § 7.43, a court may stay a derivative suit pending the corporation's investigation of the plaintiff's allegations. The MBCA does not set forth the criteria that a court should consider when determining whether to issue a stay or how long the stay should remain in effect; however, courts have noted that the determination requires balancing the "interest of the plaintiff, the interests of the defendant, all with an eye to the efficient and fair administration of justice." *Carleton, Inc. v. TLC Beatrice Int'l Holdings, Inc.*, 1996 WL 33167168, at *8–9 (Del. Ch. June 6, 1996).

Delaware courts have a strong policy in favor of staying litigation pending investigation of the claim. *See Biondi v. Scrushy*, 820 A.2d 1148, 1163 (Del. Ch. Ct. 2003) ("[T]he general rule under Delaware law is that a stay must be granted when a special litigation committee is formed"). Many other courts have followed Delaware's lead in this regard. *See, e.g.*, *Moradi v. Adelson*, 2012 WL 3687576 (D. Nev. Aug. 27, 2012) (staying action until the special litigation committee concluded its investigation); *In re: UnitedHealth Grp. Inc. Shareholder Derivative Litig.*, 2007 WL 803048 (D. Minn. Mar. 14, 2007) (staying litigation pending decision of the special litigation committee). *But see Crown Crafts, Inc. v. Aldrich*, 148 F.R.D. 547 (E.D.N.C. 1993) (declining to issue stay and finding stay of litigation more appropriate for large corporations). Ultimately, a stay will not help a corporation defend against a derivative claim, but it will permit a corporation time to investigate and analyze the claim and to prepare an appropriate response.

Seek dismissal of derivative claim. If a corporation determines that the derivative suit lacks merit, or is otherwise not in the best interests of the corporation, it can move to dismiss the action. Under MBCA § 7.44, a court must dismiss a derivative suit if the corporation has conducted a reasonable inquiry in good faith and determined that the derivative suit is not in the best interests of the corporation. Lest this appear to be a golden ticket out of court, the corporation must adhere to certain procedures and standards with respect to the investigation to gain the benefit of the provision, as discussed above.

In addition to satisfying the "reasonableness" criteria, the Board must also demonstrate that dismissal is in the best interest of the corporation. This ultimate determination requires "a balance of many factors ethical, commercial, promotional, public relations, employee relations, fiscal as well as legal." *Zapata Corp. v. Maldonado*, 430 A.2d 779, 788 (Del. Sup. Ct. 1981); *see also Auberbach*, 47 N.Y. 2d at 633 (noting that the decision falls squarely within the business judgment rule, involving the weighing of numerous factors "familiar to the resolution of many if not most corporate problems"). While one consideration may be quashing "meritless or harmful litigation," *Curtis v. Nevens*, 31 P.3d 146, 151 (Colo. Sup. Ct. 2001), courts have noted that maintaining even meritorious lawsuits may not be in the best interest of the corporation. *Cramer v. Gen. Tel. & Elecs. Corp.*, 582 F.2d 259, 275 (3d Cir. 1978) (noting that even if a suit has some merit, the litigation costs and the adverse effects may outweigh any potential benefit); *Maldonado v. Flynn*, 485 F. Supp. 274, 285 (S.D.N.Y. 1980).

Once the corporation has determined that maintaining the suit is not in the best interests of the corporation, a plaintiff seeking to maintain a derivative action must allege, with particularity, facts showing that either the directors were not qualified or that any of the other statutory requirements was not satisfied. *See, e.g.*, *Sojitz Am. Capital Corp. v. Kaufman*, 61 A.3d 566, 573-74 (Conn. App. Ct. 2013) (the statute "imposes a heightened pleading standard…requiring the plaintiffs to allege, *with particularity*," facts showing that the statutory criteria were not satisfied) (emphasis in original); *Brehm v. Eisner*, 746 A.2d 244, 254 (Del. 2000) ("Pleadings in derivative suits…must comply with stringent requirements of factual particularity….").

Just as states have adopted their own versions of the MBCA, courts have interpreted those statutes slightly differently. There is a dispute among jurisdictions concerning the appropriate deference to afford the corporation's ultimate decision that the suit is not in the best interests of the corporation. For example, in *Auerbach v. Bennett*, the New York Court of Appeals declined to review the merits of the corporation's final decision, instead confining its review to the procedures and methodologies employed. 47 N.Y.2d at 630-31. Likewise, Connecticut courts limit judicial inquiry so as to limit "unnecessary interference" with the corporation's business judgment. *Frank v. LoVetere*, 363 F.Supp.2d 327 (D. Conn. 2005).

Delaware courts, on the other hand, have held that even if the statutory criteria are met, the court must use its own business judgment to determine whether the motion to dismiss should be granted. *Zapata Corp.*, 430 A.2d at 790.

Still other courts have taken a middle ground approach, reviewing the merits with a degree of deference. *See Alford v. Shaw*, 358 S.E.2d 323, 328 (N.C. 1987) (court must make a "fair assessment" of the decision); *Houle v. Low*, 556 N.E.2d 51, 59 (Mass. 1990) (court must determine whether corporation "reached a reasonable and principled decision"); *Lewis on Behalf of Citizens Sav. Bank & Trust Co. v. Boyd*, 838 S.W.2d 215, 224 (Tenn. Ct. App. 1992) (court should review "findings and recommendations to

determine…whether they are consistent with the corporation's best interests"). Given the wide ranging views regarding the scope of judicial review, a corporation should be prepared to defend its ultimate conclusion in court.

Conclusion

The board's ultimate decision in responding to a shareholder demand will, of course, depend on a variety of facts and circumstances. Knowing the available options and being prepared to conduct an investigation in accordance with the requisite standards will enable the board to undertake a course of action that will ultimately best serve the corporation's interests.

Frederick H. Riesmeyer II is a shareholder and Kendra D. Hanson is an associate at Seigfreid Bingham, P.C., in Kansas City, Missouri. Andrew M. Zeitlin is a partner and Alison P. Baker is an associate in the Stamford, Connecticut, office of Shipman & Goodwin LLP.