

CHAPTER 1

Overview of Shareholder Derivative Litigation

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§ 1.01 The Shareholder of the Modern Corporation

It is beyond debate that the corporate form has emerged as one of the most frequently employed mechanisms through which to engage in business. This is driven largely by the fact that a corporation offers limited liability, perpetual existence, and easy transferability of interests.

Given its current status, it is perhaps surprising that the corporation was once regarded with hostility and fear. As Justice Brandeis recognized in his dissent in *Louis K. Liggett Co. v. Lee*:

“Although the value of this instrumentality [the corporation] in commerce and industry was fully recognized, incorporation for business was commonly denied long after it had been freely granted for religious, educational, and charitable purposes. It was denied because of fear. Fear of encroachment upon the liberties and opportunities of the individual. Fear of the subjection of labor to capital. Fear of monopoly. Fear that the absorption of capital by corporations, and their perpetual life, might bring evils similar to those which attended mortmain. There was a sense of some insidious menace inherent in large aggregations of capital, particularly when held by corporations. So at first the corporate privilege was granted sparingly; and only when the grant seemed necessary in order to procure for the community some specific benefit otherwise unattainable.”¹

Because of this fear, corporations were once subject to strict limitations, including limitations on the amount of authorized capital that a corporation could raise and the scope of the business to be carried on by the corporation.² Ultimately, the limitations on size and activities were eased and society witnessed the growth of huge corporate entities with distinctive characteristics.

Indeed, the modern corporation is most commonly thought of as a publicly held entity with numerous, widely dispersed small shareholders. This is not to suggest that the corporate form cannot be employed for small corporations with a limited number of shareholders, the so-called close corporation, or for corporations whose stock is privately held.³ Such entities certainly exist and flourish in our society. This book, however, focuses on the large, publicly held entities that are most commonly thought of as the prototype of the modern corporation.

¹ *Louis K. Liggett Co. v. Lee*, 288 U.S. 517, 548-549, 53 S.Ct. 481, 77 L.Ed. 929 (1933) (Brandeis, J., dissenting).

² *Id.*, 288 U.S. at 550-563. See also, Hurst, *The Legitimacy of the Business Corporation in the Law of the United States 1780-1970*, 152-153 (1970).

³ This is also not to suggest that a derivative action can only be commenced on behalf of a large, publicly held entity. Rather, “[t]he right of a stockholder to sue is not affected by the nature or kind of the corporation, and the law pertaining to derivative actions applies to a nonprofit corporation exactly the same as if it were a business corporation.” Fletcher, *Cyclopedia of Corporations* § 5949. Similarly, limited partners may commence a derivative action on behalf of the partnership. See, e.g., *Seaford Funding L.P. v. M & M Associates II, L.P.*, 672 A.2d 66 (Del. Ch. 1995). Indeed, a shareholder derivative action can even be found under appropriate circumstances to lie against the United States government. *First Hartford Corp. Pension Plan & Trust v. United States*, 194 F.3d 1279, 1293 (Fed. Cir. 1999) (“[T]he Tucker Act’s

Perhaps the most significant characteristic of the modern corporation is the separation of corporate ownership from control. Shareholders collectively own the corporation but do not, as a general rule, manage it. Rather, the authority to manage the affairs of the corporation is vested in the corporation's board of directors. As Adolph A. Berle and Gardner C. Means recognized more than half a century ago, "the corporation is a means whereby the wealth of innumerable individuals has been concentrated into huge aggregates and whereby control over this wealth has been surrendered to a unified direction," i.e., the board of directors.⁴

Does the board actually "control" the day-to-day affairs of the modern corporation? A look at the relevant state statutes would suggest that the board is, in fact, in control.⁵ The typical board of directors, however, is composed of only a few corporate officers, referred to as inside directors, and a majority of non-management, or outside, directors. These outside directors, usually placed on the board for their general business experience, individual prominence, or the prominence of the entities with which they are otherwise associated, are themselves typically occupied in the day-to-day management of other entities.⁶ Moreover, the boards generally do not meet any more frequently than once a month and often meet less frequently than that. It would therefore be impossible for even the most diligent non-management director to actually manage the corporation on a day-to-day basis.

As a natural and expected consequence, the board delegates day-to-day responsibility for running the corporation to senior management.⁷ Thus, rather than actually managing the affairs of the corporation, the board acts as an overseer ensuring that proper procedures are in place for the corporation to be run effectively. The board judges the efficacy of the corporate governance procedures and the performance of the corporation by receiving periodic reports from management and by examining the market reaction to the corporation. Furthermore, in

waiver of sovereign immunity for contract actions can extend to contract actions brought derivatively by shareholders on behalf of the contracting corporation. The procedural device of derivative actions does not broaden the scope of the waiver of sovereign immunity. Rather, in circumstances in which those in control of the management of the corporation are unable or unwilling to bring suit, it permits shareholders to step into the shoes of the corporation and file suit as fiduciaries on the corporation's behalf and for the corporation's benefit.").

⁴ Berle and Means, *The Modern Corporation and Private Property*, 4 (1991).

⁵ See, e.g.:

Delaware: 8 Del. Code Ann. § 141.

New York: N.Y. Bus. Corp. Law § 701.

⁶ See, e.g., Vise, "Bid to Boost Outside Directors' Role Assailed," *The Washington Post*, at D3 (March 26, 1993).

⁷ Berle and Means, N. 4 *supra*.

times of corporate crises the board members, given their rich backgrounds, are empowered to respond, and expert at responding, to exigent circumstances in an expeditious and effective fashion.

The necessary result of this structure leaves shareholders with a passive role in the day-to-day affairs of the corporation. To quote Berle and Means: “The property owner who invests in a modern corporation so far surrenders his wealth to those in control of the corporation that he has exchanged the position of independent owner for one in which he may become merely the recipient of the wages of capital.”⁸

What is the result of the overall separation of ownership from control? The answer depends on an assessment of the varying goals of shareholders and the managers. Shareholders have an extremely narrow and focused interest. As a group, shareholders wish to maximize the value of their holdings, both in terms of the price of their shares and the dividends paid by the corporation to the shareholders.

The interests of management are more difficult to pin down. On the one hand, it can be argued that the interests of a corporation’s management are aligned with those of the shareholders. Both groups, presumably, are interested in seeing the corporation maximize the use of its scarce resources to attain the highest levels of profit. In fact, in many instances, the compensation of the managers is based on corporate performance. Managers also are promoted based upon their ability to marshal effectively the corporation’s assets to produce high rates of return on capital. Both the common law and relevant state statutory law places a burden on the corporation’s assets to produce high rates of return on capital. Moreover, both the common law and relevant state statutory law places a burden on the corporation’s management to act in a fiduciary capacity and undertake activities that are in the best interest of the entity, even if they are opposed to the personal best interests of the manager.

Nevertheless, the separation of ownership from control can produce a condition in which the interests of the “owners” and the “managers” diverge.⁹ Rather than merely undertaking activities that contribute to a healthy “bottom line,” management might seek to increase the level of its own perquisites. Management might also attempt to increase the size of the corporation through either acquisitions or internal growth in order to heighten its own importance in the business community. In

⁸ *Id.* at 5. See also, *Bird v. Lida, Inc.*, 681 A.2d 399, 402-403 (Del. Ch. 1996) (“A fundamental condition of the corporate form when stockholders are widely dispersed, as typically occurs in public corporations, is that individual shareholders have little incentive to bear the costs associated with activities that monitor board of director (or management) performance.”).

⁹ *Id.* at 7. See *Louis K. Liggett Co. v. Lee*, 288 U.S. 517, 565, 53 S.Ct. 481, 77 L.Ed. 929 (1933).

addition, in an environment in which a corporation could be subject to a takeover, management might undertake actions to preserve its own position rather than merely obtaining the highest possible per share sales price. In these and other ways, management's interests in its own self-improvement or preservation can be seen to differ from the interests of the shareholders. As Adam Smith stated more than 200 years ago: "The directors of such companies, being the manager rather of other people's money than of their own, it cannot be expected that they should watch over it with the same anxious vigilance with which the parties in a private copartnery watch over their own."¹⁰

It is when the corporation's management, notwithstanding its fiduciary duties, favors its own interests to those of the corporation that shareholders might seek to make use of available remedies. In this regard, shareholders may try any one of three approaches: (1) shareholders can sell their shares; (2) shareholders can try to influence management by either making their concerns known to management or by electing new directors who will assert control over management in a manner that they favor; or (3) shareholders can initiate legal proceedings to hold management accountable for the breach of their duties.

It is on the last of these alternatives that this work focuses. In reviewing this book, it should be borne in mind that corporations are in fact "owned" by their shareholders and that there is a fundamental tension in the modern corporation between the owners and those in "control." Chancellor Allen of the Delaware Chancery Court elegantly described the role of derivative litigation in balancing the tension between the corporation's owners and its managers:

"A fundamental condition of the corporate form when stockholders are widely dispersed, as typically occurs in public corporations, is that individual shareholders have little incentive to bear the costs associated with activities that monitor board of director (or management) performance. Of course, a fundamental advantage that the corporate form offers to owners of capital is the utility that an investor gains through centralized management. Centralized management allows passive (low cost) ownership and promotes investor diversification. Limited liability and the entity status of a corporation similarly allow investors to be relatively passive. While the conditions that allow investors to be rationally passive are a primary source of utility, they can also lead to inefficiency to the extent centralized management may have incentives that are not perfectly aligned with those of the residual owners of the firm, which is inevitably the case. This imperfect alignment of incentives will inevitably lead to excess costs associated with centralized

¹⁰ Smith, *Wealth of Nations*, 741 (Campbell, Skinner, and Todd, eds. 1976).

management. For that reason *some* expenditures for shareholder monitoring would be efficient. Such monitoring is, of course, more or less costly to the shareholder who engages in it. In a public company with widely distributed shares, any particular shareholder has very little incentive to incur those costs himself in pursuit of a collective good since, unless there is some method to force a sharing of costs, he will bear all of the costs and only a (small) pro rata share of any gains that the monitoring yields. Thus, it is likely that in a public corporation there will be less shareholder monitoring expenditures than would be optimum from the point of the shareholders as a collectivity. One way the corporation law deals with this conundrum is through the derivative lawsuit and the recognized practice of awarding to successful shareholder champions and their attorneys risk-adjusted reimbursement payments (*i.e.*, contingency based attorneys fees). . . . The derivative suit offers to risk-accepting shareholders and lawyers a method and incentives to pursue monitoring activities that are wealth increasing for the collectivity (the corporation or the body of its shareholders). Of course that remedy itself suffers from deep agency problems and can lead to a variety of problems that for the most part can be passed over today.”¹¹

¹¹ Bird v. Lida, Inc., 681 A.2d 399, 402-403 (Del. Ch. 1996). (Citations omitted.)

§ 1.02 The Shareholder Derivative Action: Definition

Even among lawyers, the “derivative” suit is considered a relatively anomalous legal vehicle. The best way to begin to understand this odd contrivance is to set forth the prototypical case in which both direct and derivative claims can be asserted by shareholders. After setting forth the example, the nuances associated with defining and distinguishing the derivative suit from direct actions will be reviewed.

[1]—A Working Example of Shareholder Litigation

Anyone who reads the financial news will frequently encounter situations such as the following: A publicly traded high-technology company, call it Newstar, begins development of a new product. The development process requires the expenditure of a significant sum of corporate money but is undertaken with great enthusiasm by the company’s management. For a period of time, Newstar issues favorable press releases and reports in its public disclosure documents that it is optimistic about the development of its new technology. Newstar executives predict that the new technology will be a significant advance over existing technology and will enhance Newstar’s competitive position in the market when it is introduced.

Eventually Newstar’s technological advance falters. Newstar announces that a fundamental flaw in its technological process has been discovered and will result in increased costs in the development process. Subsequently, Newstar announces that the developmental barriers are insurmountable and that rather than proceed, it will write off its sizable investment in the technology. At this point, the price of Newstar’s stock falls precipitously.

From the above description, two types of injury can be said to have been suffered; the price of Newstar’s stock has fallen, and Newstar’s balance sheets have been impaired due to its write-off. Each of these distinct injuries may precipitate legal action by Newstar’s shareholders.

First, the shareholders may sue the corporation and its officials for the decline in the market value of their shares. Based on common law fiduciary duty principles or on state or federal statutes, the shareholders may allege that the recklessly optimistic statements made by corporate officials caused the shareholders to purchase and retain their shares. The shareholders may seek monetary damages in an amount that represents the difference between the purchase price of their securities and those securities’ true value, typically measured by the price at which the stock trades after the corrective disclosures are made.

This type of action is known as a direct action. It is brought either by an individual shareholder or, more likely, by a class of shareholders who are similarly situated, against the corporation and its officers and directors seeking a monetary remedy directly for the benefit of the shareholder or class of shareholders.

Second, the shareholders might seek to cause Newstar to initiate legal action on behalf of Newstar against those of its executives believed to have been responsible for the corporation's allegedly unnecessary, imprudent, and wasteful investment in the faulty technology. The recovery from the executives, if any, will be paid to Newstar and not to the shareholders who are prosecuting the lawsuit. Because the action is maintained by one or more shareholders on behalf of the corporation, it is called a derivative suit.

[2]—Defining the Derivative Suit and Distinguishing It from the Direct Action

As the example above demonstrates, and as has been stated by the Delaware Supreme Court: “A shareholder derivative suit is a uniquely equitable remedy in which a shareholder asserts on behalf of a corporation a claim belonging not to the shareholder, but to the corporation.”¹ This corporate cause of action can be asserted against corporate officers, directors, or third parties.² In order for a derivative action to

¹ *Delaware*: Levine v. Smith, 591 A.2d 194, 200 (Del. 1991), *rev'd on other grounds* by Brehm v. Eisner, 746 A.2d 244, 253 n.13 (Del. 2000).

“[T]he rule is so well settled as to require no citation of authorities that under any ordinary circumstances the fraud of the officers or managers of a corporation whereby its assets are misappropriated must be redressed by an action brought by the corporation to whom the assets belonged or by a stockholder derivatively in behalf of the corporation.”

New Jersey: Willoughby v. Chicago Junction Railway Co., 50 N.J. Eq. 656, 664, 25 A. 277, 290 (1892).

New York: Brock v. Poor, 216 N.Y. 387, 396, 111 N.E. 229, 232 (1915).

“A stockholder, as such does not have a legal or equitable estate in the corporate property; his only right of property is to a proportionate share of the profits of the business while the company is in operation, and to a proportionate share of the net assets on its dissolution. Unauthorized dealing with the franchises or funds of the corporation directly injure it as a legal entity; it is the franchises of the corporation which are to be misused, the funds of the corporation which are to be misappropriated, and the corporation is therefore the party to be injured and should itself seek redress.”

² See Ross v. Bernhard, 396 U.S. 531, 534, 90 S.Ct. 733, 24 L.Ed.2d 729 (1970). But see, McDermott, Will & Emery v. Superior Court of Los Angeles County, 83 Cal. App.4th 378, 99 Cal. Rptr.2d 622 (2000). In *McDermott*, the court concluded that a derivative malpractice action brought by shareholders against a corporation's outside counsel could not proceed because of attorney-client privilege issues. *Id.*, 99 Cal. Rptr.2d at 624. The court recognized that shareholders may normally proceed in a derivative action against third parties; however, in a derivative malpractice action, the outside attorney would be foreclosed from mounting a meaningful defense because California's Code of Evidence does not permit shareholders to waive the attorney-client privilege held by the corporation under any circumstances. *Id.* Absent a waiver of the privilege by the corporation, the court ruled that “such a derivative action

exist, the corporation must suffer some palpable injury for which it seeks redress against purported wrongdoers, e.g., corporate officers. That is, the “right claimed by the shareholder is one the corporation could itself have enforced in court.”³

This is not to suggest that a derivative suit will result in only the granting of equitable relief or even that the derivative suit is itself a form of equitable relief.⁴ The shareholder derivative action is a mechanism through which shareholders can monitor and redress harm to the corporation caused by management in cases in which management is unlikely to redress the harm itself. Justice William O. Douglas defined the derivative suit as “one of the remedies which equity designed for those situations where the management through fraud, neglect of duty or other cause declines to take the proper and necessary steps to assert the rights which the corporation has.”⁵ As the Supreme Court more recently summarized:

“[T]he purpose of the derivative action was to place in the hands of the individual shareholder a means to protect the interests of the corporation from the misfeasance and malfeasance of ‘faithless directors and managers.’”⁶

Indeed, although at least one court has noted that “derivative actions are not favored in the law because they ask courts to second-guess the business judgment of the individuals charged with managing the company,” this same court recognized these suits’ importance to current corporate governance structures, as they serve the “important purpose of protecting corporations and minority shareholders against offers and directors who, in discharging their official responsibilities, place other interests ahead of those of the corporation.”⁷

against the corporation’s outside counsel, necessarily brought in equity, cannot proceed.” *Id.* Note, however, that “California’s approach to confidentiality ostensibly is the strictest in the United States.” Zacharias, “Privilege and Confidentiality in California,” 28 U.C. Davis L. Rev. 367, 372 n.18 (1995). (The implication is that this case would have probably been decided differently in another state.)

³ *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 529, 104 S.Ct. 831, 78 L.Ed.2d 645 (1984) (citing *Koster v. (American) Lumbermens Mutual Casualty Co.*, 330 U.S. 518, 522, 67 S.Ct. 828, 91 L.Ed. 1067 (1947)); *Price v. Gurney*, 324 U.S. 100, 105, 65 S.Ct. 513, 89 L.Ed. 776 (1945); *Delaware & Hudson Co. v. Albany & S.R. Co.*, 213 U.S. 435, 447, 29 S.Ct. 540, 53 L.Ed. 862 (1909).

⁴ “Although the origins of the derivative suit are in equity . . . the derivative suit, however, is not a form of equitable relief, but rather a procedural device.” *First Hartford Corp. Pension Plan & Trust v. United States*, 194 F.3d 1279, 1294-1295 (Fed. Cir. 1999).

⁵ *Meyer v. Fleming*, 327 U.S. 161, 167, 66 S.Ct. 382, 90 L.Ed. 595 (1946).

⁶ *Kamen v. Kemper Financial Services, Inc.*, 500 U.S. 90, 95, 111 S.Ct. 1711, 114 L.Ed.2d 152 (1991) (quoting *Cohen v. Beneficial Industrial Loan Corp.*, 337 U.S. 541, 548, 69 S.Ct. 1221, 93 L.Ed. 1528 (1949)).

⁷ *Bansbach v. Zinn*, 801 N.E.2d 395, 400 (N.Y. 2003).

It should be emphasized that a derivative suit is not brought by shareholders as individuals seeking redress for injury caused to them personally, but as representatives of the corporation seeking redress on behalf of the company for harm caused to it.⁸ In effect, the shareholder derivative action is actually two causes of action: “one against the directors for failing to sue; the second based upon the right belonging to the corporation.”⁹ The derivative nature of the action stems from the fact that the action is commenced by a shareholder on behalf of the corporation rather than by the corporation itself. As the Delaware Court of Chancery has stated, “[a] wrong is derivative in nature when it injures the shareholders indirectly and dependently through direct injury to the corporation.”¹⁰

Literally, an action is derivative in nature when it is brought by a shareholder on behalf of the corporation as a whole for harm suffered by all shareholders in common. An action brought by a shareholder for harm done exclusively to that person must proceed as a direct action by the individual (or a class of individuals) against the purported wrongdoers regardless of how the action is initially styled.

⁸ See:

Second Circuit: Lasker v. Burks, 404 F. Supp. 1172 (S.D.N.Y. 1975).

Sixth Circuit: Wilson v. Continental Development Co., 112 F. Supp.2d 648, 661 (W.D. Mich. 1999), *aff'd* 234 F.3d 1271 (6th Cir. 2000) (dismissing derivative claim that only asserted personal injury and not injury to the corporation).

See also: Henn and Alexander, *Laws of Corporations and Other Business Enterprises* § 360 (3d ed. 1983); Garrard, “The Stockholder’s Suit—Corporate and Individual Grievances,” 33 Yale L.J. 580 (1923).

⁹ Brown v. Tenney, 125 Ill.2d 348, 532 N.E.2d 230, 232 (1988). See, e.g., Daily Income Fund, Inc. v. Fox, 464 U.S. 523, 529 n.4, 104 S.Ct. 831, 78 L.Ed.2d 645 (1984) (quoting Note, “Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit,” 73 Harv. L. Rev. 746, 748 (1960)):

“[T]he derivative suit may be viewed as the consolidation in equity of, on the one hand, a suit by the shareholder against the directors in their official capacity, seeking an affirmative order that they sue the alleged wrongdoers, and, on the other, a suit by the corporation against these wrongdoers.”

See also: Louisiana Municipal Police Employees Retirement System v. Pyott, 46 A.3d 313, 329 (Del. 2012) (noting that, as to the two stages of a derivative case, “[t]he former belongs to the complaining stockholders; the latter to the corporation”); Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984), *rev’d on other grounds by* Brehm v. Eisner, 746 A.2d 244, 253 n.13 (Del. 2000) (“The nature of the action is two-fold. First, it is the equivalent of a suit by the shareholders to compel the corporation to sue. Second, it is a suit by the corporation, asserted by the shareholders on its behalf, against those liable to it.”).

¹⁰ Avacus Partners, L.P. v. Brian, 16 Del. J. Corp. L. 1425 (Del. Ch. 1990). See also, Kramer v. Western Pacific Industries, Inc., 546 A.2d 348, 353 (Del. 1988) (holding that a claim of mismanagement resulting in corporate waste “if proven, represents a direct wrong to the corporation that is indirectly experienced by all shareholders. Any devaluation of the stock is shared collectively by all the shareholders, rather than independently by the plaintiff or any other individual shareholder. Thus, the wrong alleged is entirely derivative in nature.”).

Conversely, an action filed by a single shareholder, even if styled as an individual action, will have to proceed as a derivative action (meeting all the procedural prerequisites for such an action) if the harm alleged by the shareholder was suffered by that shareholder in common with all other shareholders of the corporation.¹¹ The ultimate disposition of a derivative action may have a binding effect on all other shareholders of the corporation even though it is instituted and maintained by a single shareholder.

The crucial distinction, then, between direct and derivative actions is that in the former case the shareholder is suing to redress an injury sustained directly by him with the recovery going to that person or to the class of which he is a member.¹² In addition, the corporation in the direct action is the defendant rather than the beneficiary of the suit.

Overall, “the line of distinction between derivative suits and those brought for the enforcement of personal rights asserted on behalf of a class of stockholders is often a narrow one, the latter type of actions being designed to enforce common rights running against plaintiffs’ own corporation or those dominating it, while the former are clearly

¹¹ See, e.g., *Behrens v. Aerial Communications Inc.*, 2001 WL 599870 (Del. Ch. May 18, 2001), *overruled in part by* *Gentile v. Rossette*, 906 A.2d 91, 103 n.28 (Del. 2006) (dismissing former minority shareholder’s complaint because claims were derivative in nature, despite being styled as direct claims, and therefore were extinguished when original corporation was merged into another). See also, *Danielewicz v. Arnold*, 137 Md. App. 601, 769 A.2d 274, 291 (Md. Ct. Spec. App. 2001) (finding that majority shareholder could bring only a derivative suit even though she claimed corporate directors conspired to purposefully divest her of majority ownership through an overvalued transaction).

¹² Note, “Distinguishing Direct and Derivative Shareholder Suits,” 110 U. Pa. L. Rev. 1147 (1962). See *Alabama By-Products Corp. v. Cede & Co.*, 657 A.2d 254, 266 (Del. 1995) (“while the line of separation between derivative and corporate class actions is sometimes obscure, the derivative and appraisal actions are clearly distinct. The obvious difference between the two proceedings is that an appraisal petitioner sues in his own right instead of on behalf of the corporation. In an appraisal proceeding, the cause of action, as well as any recovery, belongs to the dissenting shareholders, not the corporation.”). In *Tooley v. Donaldson, Lufkin & Jenrette Inc.*, 845 A.2d 1031 (Del. 2004), the Delaware Supreme Court clarified its position by distinguishing between the direct claims of shareholders and derivative claims. The court opined that, “[f]or purposes of distinguishing between derivative and direct claims, we expressly disapprove both the concept of ‘special injury’ and the concept that a claim is necessarily derivative if it affects all stockholders equally.” *Id.* at 1039. Further, the court stated that in order to determine whether a claim is derivative or direct, such analysis “must turn solely on the following questions: (1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually).” *Id.* at 1033 (disapproving of *In re Tri-Star Pictures, Inc. Litigation*, 634 A.2d 319 (Del. 1993)). See also: *Id.* at 1038 n.21; *Lipton v. News International, Plc.*, 514 A.2d 1075 (Del. 1986).

for the purpose of remedying wrongs to the corporation itself.”¹³ The same set of facts can give rise to both direct and derivative claims.¹⁴ Characterizations made in the pleadings are not controlling.¹⁵ Nor is

¹³ *Abelow v. Symonds*, 38 Del. Ch. 572, 156 A.2d 416, 420 (1959). See also:

First Circuit: *Estate of Soler v. Rodriguez*, 63 F.3d 45 (1st Cir. 1995) (derivative action is appropriate legal vehicle where an action is brought pursuant to Section 10(b) of the Securities Exchange Act of 1934 on behalf of the corporation against the chairman of the board of directors and others in connection with the sale of the corporation’s own stock for insufficient consideration).

Seventh Circuit: *Boland v. Engle*, 113 F.3d 706 (7th Cir. 1997) (Investment Company Act claims that attempt to assert the rights of investment companies should be brought derivatively).

State Courts:

Delaware: *Parnes v. Bally Entertainment Corp.*, 722 A.2d 1243, 1245 (Del. 1999) (“Stockholders may sue on their own behalf (and, in appropriate circumstances, as representatives of a class of stockholders) to seek relief for direct injuries that are independent of any injury to the corporation.”); *Grimes v. Donald*, 673 A.2d 1207 (Del. 1996), *rev’d on other grounds by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000) (claims alleging failure to exercise due care, waste of corporate assets and excessive compensation were derivative; claim alleging abdication by board of statutory duties was direct); *Lewis v. Spencer*, 577 A.2d 753, 754 (Del. 1990) (“To have standing to sue individually, rather than derivatively on behalf of the corporation, a plaintiff must allege more than an injury resulting from a wrong to the corporation. . . . For a plaintiff to have standing to bring an individual action, he must be injured directly or independently of the corporation.”). See also: *Gotham Partners, L.P. v. Hallwood Realty Partners L.P.*, 1998 Del. Ch. LEXIS 226 (Nov. 10, 1998) (holding that claims that a transaction adversely affected unit holders’ voting rights are individual rather than derivative); *In re First Interstate Bancorp Consolidated Shareholder Litigation*, 729 A.2d 851 (Del. Ch. 1998), *aff’d sub nom. Bradley v. First Interstate Bancorp*, 748 A.2d 913 (Del. 2000).

Maryland: *Tafflin v. Levitt*, 92 Md. App. 375, 608 A.2d 817 (1992), *cert. denied* 328 Md. 426 (1992); *Waller v. Waller*, 187 Md. 185, 49 A.2d 449 (Ct. Spec. App. 1946). See also, *Strougo ex rel. Brazilian Equity Fund, Inc. v. Bassini*, 282 F.3d 162, 169 (2d Cir. 2002) (interpreting Maryland law).

New York: *Yudell v. Gilbert*, 949 N.Y.S.2d 380 (N.Y. App. Div. 1st Dep’t 2012) (adopting the *Tooley* test, N. 12 *supra*, to distinguish direct and derivative claims).

¹⁴ See, e.g.:

Supreme Court: *J. I. Case Co. v. Borak*, 377 U.S. 426, 84 S.Ct. 1555, 12 L.Ed.2d 423 (1964), *abrogated on other grounds by Touche Ross & Co. v. Redington*, 442 U.S. 560, 99 S.Ct. 2479, 6 L.Ed.2d 82 (1979). But see , *KBR Inc. v. Chevedden*, 776 F. Supp.2d 415, 424 (S.D. Tex. 2011) (acknowledging that “[t]he Supreme Court has exercised greater restraint in implying private rights of action and has been critical of *Borak’s* reasoning”).

State Courts:

Alaska: *Hanson v. Kake Tribal Corp.*, 939 P.2d 1320 (Alaska 1997).

Delaware: *Grimes v. Donald*, 673 A.2d 1207 (Del. 1996), *rev’d on other grounds by Brehm v. Eisner*, 746 A.2d 244, 253 n.13 (Del. 2000); *Katz v. Halperin*, 21 Del. J. Corp. L. 690 (Del. Ch. 1996).

¹⁵ *Second Circuit*: *Rubenstein v. Skyteller, Inc.*, 48 F. Supp.2d 315, 322 (S.D.N.Y. 1999) (the court is not bound by the designation employed by the plaintiff in determining whether an action is direct or derivative).

Third Circuit: *Kalmanovitz v. G. Heileman Brewing Co.*, 595 F. Supp. 1385, 1389 (D. Del. 1984), *aff’d* 769 F.2d 152 (3d Cir. 1985).

the type of action dispositive, even if it is one that is typically brought as a direct or derivative claim. For example, a claim for corporate waste, while usually indicative of a derivative claim, may be raised in a direct action under appropriate circumstances.¹⁶ Instead, the court must look to the body of the complaint and the nature of the alleged wrong.¹⁷ In some cases, courts will also look to the adequacy of the remedies available under each type of action.¹⁸ Indeed, it should be noted that courts “have wide discretion in interpreting whether a complaint states a derivative or a primary claim.”¹⁹ In fact, some states give courts discretion to treat an action brought by a shareholder in a closely held corporation as a direct action rather than a derivative action.²⁰ However, Delaware and most other states have not adopted the so-called “closely held corporation exception.”²¹

One commentator has helpfully set forth the following test for distinguishing direct from derivative actions:

“[T]o determine whether a particular claim for relief should be enforced through a direct action or derivatively, it must be ascertained whether the situation in question calls for the maintenance of the corporate personality to protect creditors, to avoid multiple suits, or to continue corporate control over the disposition of invested capital.”²²

Seventh Circuit: Seidel v. Allegis Corp., 702 F. Supp. 1409, 1411 (N.D. Ill. 1989).

State Courts:

Pennsylvania: Mogilyansky v. Sych, 2002 WL 372950, at *2 (Pa. Ct. Com. Pl. Feb. 4, 2002) (“Pennsylvania courts faced with a conflict between the allegations of a count and the count’s title look at the allegations and not the title.”).

¹⁶ Rubenstein v. Skyteller, Inc., 48 F. Supp.2d 315, 323 (S.D.N.Y. 1999).

¹⁷ *Id.*, 48 F. Supp.2d at 322-323 (examining the body of the complaint and finding that it stated both direct and derivative claims).

State Courts:

Delaware: Kramer v. Western Pacific Industries, Inc., 546 A.2d 348, 352 (Del. 1988); Winston v. Mandor, 710 A.2d 835 (Del. Ch. 1997) (finding claims of corporate waste filed directly to be derivative, and giving leave to amend complaint); Elster v. American Airlines, Inc., 34 Del. Ch. 94, 100 A.2d 219, 221-223 (Del. Ch. 1953).

¹⁸ Hanson v. Kake Tribal Corp., 939 P.2d 1320 (Alaska 1997).

¹⁹ *Id.*, 939 P.2d at 1327. See, e.g., Minor v. Albright, 2001 WL 1516729, at *3 (N.D. Ill. Nov. 28, 2001) (majority shareholders’ attempts to freeze out minority shareholders cause distinct injuries, creating individual and not derivative claims).

²⁰ See, e.g.:

Indiana: Barth v. Barth, 659 N.E.2d 559, 562 (Ind. 1995).

Kansas: Boyle v. Harries, 22 Kan. App.2d 686, 923 P.2d 504, 512 (1996).

See also, 2 American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* § 7.01(d) (1994) (advocating treatment of derivative claims as direct actions in the case of closely held corporations).

But see, Landstrom v. Shaver, 1997 S.D. 25, 561 N.W.2d 1, 13 (1997) (holding that such states are in the minority).

²¹ See, e.g., Simmons v. Miller, 261 Va. 561, 575, 544 S.E.2d 666, 675 (2001) (declining to adopt the closely held corporation exception).

The commentator concludes that when any of the above-mentioned protections are necessary, the action is properly brought derivatively on behalf of the corporation and not directly by shareholders.²³

What is the relevance of the characterization of an action as direct or derivative? Aside from presenting intriguing theoretical questions, the distinction has critical practical significance. As will be discussed,²⁴ there are procedural barriers to commencing a derivative action, including the need to make a pre-suit demand on the company's board of directors to bring the suit. In addition, as has previously been mentioned, shareholders bringing a derivative action do not enjoy any direct monetary benefit from their suit; their only gains from a successful derivative action are due to the increased value of the corporation in which they hold interest.

With its many disadvantages, is the derivative suit still a viable legal vehicle and, if so, why? These questions are taken up, in part, in the discussion of the history of the derivative suit.²⁵

²² Note, "Distinguishing Between Direct and Derivative Shareholder Suits," 110 U. Pa. L. Rev. 1147, 1149 (1962).

²³ *Id.* It should be noted that in a diversity action, the characterization of an action as derivative or direct is a question of state law. *Sax v. World Wide Press, Inc.*, 809 F.2d 610, 613 (9th Cir. 1987).

²⁴ See Chapters 3 and 4 *infra*.

²⁵ See § 1.03 *infra*.

§ 1.03 History

[1]—Early History

The derivative suit is the result of the tumultuous marriage of shareholders and management, with the fracture of the union being expressed by the derivative suit. Simply stated, the history of the derivative action is merely an expression of the tension between shareholders and management.

Although earlier American authority can be cited,¹ the Supreme Court's decision in *Dodge v. Woolsey*² firmly established the equitable jurisdiction of American courts to entertain shareholders' derivative actions. In *Dodge v. Woolsey*, a shareholder of the Branch Bank of Cleveland sought to enjoin the bank from paying, and the state of Ohio from collecting, an allegedly unconstitutional tax on the revenues of the bank. Mr. Woolsey named as defendants George Dodge, the Ohio tax collector, the directors of the bank and the bank itself. At the time of the suit, it was established that the common law would not "permit stockholders to call corporate managers to account in actions at law."³ Mr. Woolsey was therefore forced to turn to the only remaining avenue for relief, i.e., equity. Fortunately for Mr. Woolsey, equity supplied the remedy missing at law. Indeed, the Supreme Court acknowledged the jurisdiction of the court in resounding terms:

"It is now no longer doubted, either in England or the United States, that courts of equity, in both, have a jurisdiction over corporations at the instance of one or more of their members; to apply preventive remedies by injunction, to restrain those who administer them from doing acts which would amount to a violation of charters, or to prevent any misapplication of their capitals or profits, which might result in lessening the dividends of stockholders, or the value of their shares, as either may be protected by the franchises of a corporation, if the acts intended to be done create what is in the law denominated a breach of trust."⁴

¹ See, e.g.:

New York: *Robinson v. Smith*, 3 Paige Ch. 222, 231-232 (N.Y. 1832); *Attorney General v. Utiva Insurance Co.*, 2 Johns. Ch. 371, 389-390 (N.Y. 1817).

Ohio: *Taylor v. Miami Exporting Co.*, 5 Ohio 162 (1831).

These cases are thoughtfully reviewed in Hornstein, "The Shareholder's Derivative Suit in the United States," J. Bus. L. 282, 284 (1967). For a review of the history of the derivative action in the United States and in England, see Prunty, "The Shareholder's Derivative Suit: Notes on Its Derivation," 32 N.Y.U. L. Rev. 980 (1957).

² *Dodge v. Woolsey*, 59 U.S. (18 How.) 331, 15 L.Ed. 401 (1855).

³ *Ross v. Bernhard*, 396 U.S. 531, 534, 90 S.Ct. 733, 24 L.Ed.2d 729 (1970).

⁴ *Dodge v. Woolsey*, N. 2 *supra*, 59 U.S. (18 How.) at 341.

The reason the Supreme Court so readily assumed jurisdiction is one which is not unfamiliar. That is, the Supreme Court's underlying rationale was rooted in the separation of ownership from control. This is elegantly explained by the Court in *Cohen v. Beneficial Industrial Loan Corp.*:

“As business enterprise increasingly sought the advantages of incorporation, management became vested with almost uncontrolled discretion in handling other people's money. The vast aggregate of funds committed to corporate control came to be drawn to a considerable extent from numerous and scattered holders of small interests. The director was not subject to an effective accountability. That created strong temptation for managers to profit personally at expense of their trust. The business code became all too tolerant of such practices. Corporate laws were lax and were not self-enforcing, and stockholders, in the face of the gravest abuses, were singularly impotent in obtaining redress of abuses of trust.”⁵

Equity came to the relief of the stockholder, who had no standing to bring a civil action at law against faithless directors and managers, and equity allowed him to step into the corporation's shoes and to seek, on behalf of the corporation, the restitution he could not demand on his own.⁶

Apart from its assertion of jurisdiction, several other salient points should be made regarding the Supreme Court's decision in *Dodge v. Woolsey*. First, it should be noted that prior to instituting the lawsuit, Mr. Woolsey requested that the board of directors take measures to prevent the collection of the tax. This request, later known as a “demand,” was then a standard precursor to filing a derivative suit⁷ and has since been made a prerequisite to the commencement of derivative litigation.⁸

Second, the Court drew a distinction between cases in which there is a breach of trust by the directors, managers or third parties and those in which there has only been an error or misapprehension or

⁵ *Cohen v. Beneficial Industrial Loan Corp.*, 337 U.S. 541, 69 S.Ct. 1221, 93 L.Ed. 1528 (1949).

⁶ *Id.*, 337 U.S. at 547-548.

⁷ See Prunty, “The Shareholders' Derivative Suit: Notes on Its Derivation,” 32 N.Y.U. L. Rev. 980, 992 (1957) (making a demand prior to instituting derivative litigation “was characteristic of such suits as are reported during this period”).

⁸ The demand requirement is discussed in detail at Chapters 3 and 6 *infra*.

simple negligence.⁹ In the latter case, the Court found that no liability would attach to the actions of directors, managers or third parties.¹⁰ This distinction should be kept in mind as it foreshadows the business judgment rule.¹¹

Having granted equity jurisdiction to shareholders to prosecute their derivative claims, it only seems fitting that the results of the Supreme Court's next consideration of the scope of the derivative action was to narrow the availability of the remedy. In *Hawes v. Oakland*,¹² a shareholder in the Contra Costa Waterworks Company complained that the city of Oakland, California was improperly demanding that the Contra Costa Waterworks Company provide the city with water free of charge. The shareholder named as defendants not only the city for demanding the water, but also the directors of the company for complying with the city's demand.

Justice Miller, writing for the Court, began by taking judicial notice of the fact that since the Court's decision in *Dodge v. Woolsey*, numerous shareholders' derivative suits had been filed.¹³ In the wake of these suits, Justice Miller sought to set out guidelines for the circumstances under which shareholder actions could properly be found to lie.

“[T]o enable a stockholder in a corporation to sustain in a court of equity in his own name, a suit founded on a right of action existing in the corporation itself, and in which the corporation itself is the appropriate plaintiff, there must exist as the foundation of the suit—

“Some action or threatened action of the managing board of directors or trustees of the corporation which is beyond the authority conferred on them by their charter or other source of organization;

“Or such a fraudulent transaction completed or contemplated by the acting managers, in connection with some other party, or among themselves, or with other shareholders as will result in serious injury to the corporation, or to the interests of the other shareholders;

“Or where the board of directors, or a majority of them, are acting for their own interest, in a manner destructive of the corporation itself, or of the rights of the other shareholders;

“Or where the majority of shareholders themselves are oppressively and illegally pursuing a course in the name of the corporation,

⁹ *Dodge v. Woolsey*, 59 U.S. (18 How.) 331, 343-344, 15 L.Ed. 401, 406 (1855).

¹⁰ *Id.*

¹¹ See Chapter 5 *infra*.

¹² *Hawes v. Oakland*, 104 U.S. (14 Otto) 450, 26 L.Ed. 827 (1882), *abrogated by* *Kamen v. Kemper Financial Services, Inc.*, 500 U.S. 90, 111 S.Ct. 1711, 114 L.Ed.2d 152 (1991).

¹³ *Id.*, 104 U.S. (14 Otto) at 451.

which is in violation of the rights of the other shareholders, and which can only be restrained by the aid of a court of equity.

“Possibly other cases may arise in which, to prevent irremediable injury, or a total failure of justice, the court would be justified in exercising its powers, but the foregoing may be regarded as an outline of the principles which govern this class of cases.”¹⁴

Justice Miller also set several procedural limitations on shareholders’ ability to institute derivative proceedings. First, he established the demand requirement.

“[B]efore the shareholder is permitted in his own name to institute and conduct a litigation which usually belongs to the corporation, he should show to the satisfaction of the court that he has exhausted all the means within his reach to obtain, within the corporation itself, the redress of his grievances, or action in conformity to his wishes. He must make an earnest, not simulated effort, with the managing body of the corporation, to induce remedial action on their part, and this must be made apparent to the court. If time permits or has permitted, he must show, if he fails with the directors, that he has made an honest effort to obtain action by the stockholders as a body, in the matter of which he complains. And he must show a case, if this is not done, where it could be done, or it was not reasonable to require it.”¹⁵

Second, Justice Miller created the requirement of contemporaneous ownership.¹⁶ That is, a shareholder derivative complaint was required to contain “an allegation that complainant was a shareholder at the time of the transactions of which he complains, or that his shares have devolved on him since by operation of law. . . .”¹⁷ Third, the

¹⁴ *Id.* at 460. One of the other issues obviously weighing on the mind of Justice Miller related to the grant of federal question jurisdiction to the federal courts. See Act of March 3, 1875, 18 Stat. 470 (1875). At the time when *Dodge v. Woolsey*, Ns. 2-4 and accompanying text *supra*, was decided, the bank could not sue the tax collector because they were both citizens of Ohio. Thus, the only way to obtain federal court jurisdiction was to have a shareholder whose citizenship was outside Ohio bring the suit under the federal court’s diversity jurisdiction. With the promulgation of federal question jurisdiction, however, the bank could sue the state collection directly in federal court. In Justice Miller’s mind, the need for the shareholder derivative suit was diminished.

¹⁵ *Hawes v. Oakland*, N. 12 *supra*, 104 U.S. (14 Otto) at 460-461. (Citation omitted.)

¹⁶ The contemporaneous ownership requirement is examined in greater detail at Chapter 4 *infra*.

¹⁷ *Hawes v. Oakland*, N. 12 *supra*, 104 U.S. (14 Otto) at 461.

complainant was required to allege that the suit was not a collusive one to confer jurisdiction on a federal court in a case of which it would otherwise have no cognizance.¹⁸

On January 23, 1882, to implement the procedural limitations that it set forth in *Hawes v. Oakland*, the Supreme Court adopted Equity Rule 94,¹⁹ which was recodified without substantial change as Equity Rule 27²⁰ and still later as Federal Rule of Civil Procedure 23(b).²¹

¹⁸ *Id.* This requirement relates to Justice Miller's concern that shareholder derivative actions had been used to allow federal courts to obtain diversity jurisdiction over matters with which they would otherwise not have a jurisdictional basis to hear.

¹⁹ Equity Rule 94 provided:

"Every bill brought by one or more stockholders in a corporation, against the corporation and other parties, founded on rights which may properly be asserted by the corporation, must be verified by oath, and must contain an allegation that the plaintiff was a shareholder at the time of the transaction of which he complains, or that his share had devolved on him since by operation of law; and that the suit is not a collusive one to confer on a court of the United States jurisdiction of a case of which it would not otherwise have cognizance. It must also set forth with particularity the efforts of the plaintiff to secure such action as he desires on the part of the managing directors or trustees, and, if necessary, of the shareholders, and the causes of his failure to obtain such action."

²⁰ Equity Rule 27 provided:

"Every bill brought by one or more stockholders in a corporation against the corporation and other parties, founded on rights which may properly be asserted by the corporation, must be verified by oath, and must contain an allegation that the plaintiff was a shareholder at the time of the transaction of which he complains, or that his share had devolved on him since by operation of law, and that the suit is not a collusive one to confer on a court of the United States jurisdiction of a case of which it would not otherwise have cognizance. It must also set forth with particularity the efforts of the plaintiff to secure such action as he desires on the part of the managing directors or trustees, and, if necessary, of the shareholders, and the causes of his failure to obtain such action, or the reasons for not making such effort."

²¹ Rule 23(b) was promulgated as part of the adoption of the Federal Rules of Civil Procedure in 1938. Rule 23(b) provided:

"In an action brought to enforce a secondary right on the part of one or more shareholders in an association, incorporated or unincorporated, because the association refuses to enforce rights which may properly be asserted by it, the complaint shall be verified by oath and shall aver (1) that the plaintiff was a shareholder at the time of the transaction of which he complains or that his share thereafter devolved on him by operation of law and (2) that the action is not a collusive one to confer on a court of the United States jurisdiction of any action of which it would not otherwise have jurisdiction. The complaint shall also set forth with particularity the efforts of the plaintiff to secure from the managing directors or trustees and, if necessary, from the shareholders such action as he desires, and the reasons for his failure to obtain such action or the reasons for not making such effort."

With its place in American jurisprudence firmly fixed through Supreme Court decisions and a federal rule of procedure, it would seem that the derivative suit would have merely blended with the body of law. This, however, did not turn out to be true. In providing shareholders with a shield against faithless management, the law had also given abusive shareholders a sword to stab into the hearts of faithful management. With the growth of the derivative suit came the “strike suit,” that is, a suit brought by a shareholder without a substantial basis in law or fact simply for the purpose of obtaining an extortion-like settlement from the defendants or the corporation’s management.

By the 1920s, one such strike suiter, Clarence Venner, had instituted nineteen suits, was the subject of numerous articles on his practices, and had earned the nickname “Sue and Settle” Venner.²² So well known were Venner’s tactics that it caused one judge to write: “I can conceive of no monster of the jungle, or the most vivid imagination, that could unsettle the nerves of a corporation director when engaged in rejuvenating an embarrassed company, as the appearance of Mr. Venner in search of information.”²³

The response to these perceived abuses came first from the New York legislature. It began when the New York Chamber of Commerce formed a special committee on corporate litigation in order to “determine the advisability of possible changes in law or procedure which would facilitate the correction of wrongdoing in corporate affairs but reduce groundless and costly litigation.”²⁴

“The special committee’s *Report*, completed in February 1944, criticized frequent abuses of derivative litigation. The committee found that most minority derivative suits were brought by stockholders having no financial interest in prosecuting the suit, and that the bulk of the litigation was handled by a limited number of attorneys. . . . To remedy these alleged abuses, the *Report* recommended that a new section be added to the [New York] General Corporation Law which would require minority shareholders, upon the motion of the corporation involved, to post a bond as security for all the corporation’s reasonable expenses, including its attorney’s fees.”²⁵

²² See, e.g.: Sears, *The New Place of the Stockholder* 199 (1929); Time, July 3, 1933, p. 52; The New York Times, June 26, 1933; Time, Nov. 21, 1922, p. 37.

²³ General Investment Co. v. American Hide & Leather Co., 97 N.J. Eq. 214, 127 A. 529, 535 (N.J. Ch.), *aff’d* 98 N.J. Eq. 326, 129 A. 244 (1925).

²⁴ Wood, *Survey and Report Regarding Derivative Suits* 27-29 (1944).

²⁵ Note, “Security for Expenses in Shareholders’ Derivative Suits: Twenty-Three Years’ Experience,” 4 Colum. J.L. & Soc. Probs. 50, 52 (1968).

Shortly after the report was published, the New York legislature passed a bill that was signed into law by then-governor Thomas Dewey, creating New York's security-for-expenses statute. Overall, "the statute was enacted to meet the evil posed by baseless strike stockholders' suits against corporate directors and stockholders."²⁶ It was hoped that a "stockholder motivated by personal gain instead of the welfare of the corporation . . . would be deterred from bringing a spurious action, when the onus of the expense incurred by the corporation in defending it would be ultimately cast on the plaintiff as a consequence of the exposure of the action as meritless."²⁷

Following New York's lead, sixteen states enacted security-for-expenses statutes. It should be recognized that this represents a small minority, approximately one-third, of the states. Importantly, it should be noted further that Delaware, the leading jurisdiction on corporate law matters, does not have such a statute.

For a time, the adoption of security-for-expenses statutes was heralded by commentators as the death knell for the derivative suit.²⁸ This did not turn out to be the case. Instead, clever plaintiffs found ways to plead around the security-for-expenses statutes²⁹ and it is the statutes, rather than the derivative action, that appear to be on their last leg. In fact, in 1966, rather than falling into disfavor or obsolescence, the derivative action was given its own rule of federal procedure, i.e., Rule 23.1 which retained the procedural limitations contained in Rule 23(b) and added two procedural requirements that had previously been applied to derivative actions but which were not embodied in the former federal rule. These additional requirements are that (1) a plaintiff prosecuting a derivative action must fairly and adequately represent the interests of the shareholders of the corporation,³⁰ and (2) a derivative action cannot be compromised or settled without court approval.³¹

²⁶ *Roach v. Franchises International, Inc.*, 32 A.D.2d 247, 250, 300 N.Y.S.2d 630, 633 (N.Y. App. Div. 1969).

²⁷ *Id.*, 32 A.D.2d at 250, 300 N.Y.S.2d at 633.

²⁸ See Coffee and Schwartz, "The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform," 81 Colum. L. Rev. 261 (1981).

²⁹ A.L.I., *Principles of Corporate Governance: Analysis and Recommendations*, § 7.04, note g (Proposed Final Draft March 31, 1992).

"Most typically, plaintiffs avoid state security statutes by pleading a federal cause of action. Alternatively, plaintiffs may seek inspection of the corporation's stock book in order to urge other shareholders to join in the suit and thereby satisfy the 5 percent threshold employed by many statutes to exempt plaintiffs with significant shareholders from the application of the statute."

³⁰ See § 4.05 *infra*.

³¹ Court approval of settlement is discussed in detail in Chapter 13 *infra*.

Thus, by 1967, commentators had shifted from foretelling the death of the derivative action to proclaiming its revival.³² In his article, Professor Dykstra noted that for the period 1956 through 1966, more than 470 derivative suits were *reported* in the decennial digest, representing an increase of 160 over the number reported in the prior decade and likely representing only a small fraction of the number of such cases filed.³³

By the early 1980s, a new threat to the derivative action emerged. The Supreme Court's decision in *Burks v. Lasker*,³⁴ combined with the New York Court of Appeals' decision in *Auerbach v. Bennett*,³⁵ appeared to place great power in the hands of a board of directors to refuse to initiate a derivative suit after demand was made. Again commentators began to predict that the derivative action would surely perish, particularly if legislative action was not taken.³⁶

Once again the derivative action proved more resilient than commentators believed. Plaintiffs have continued to assert derivative claims, sometimes circumventing the federal rules' procedural barriers by asserting that demand on the board is futile and thereby taking the case away from the full board of directors.

Will the derivative suit now be left alone, free of further judicial or legislative burdens? Most likely, the answer is no. Will the derivative suit survive the next challenge? The answer is probably.

[2]—Derivative Suits Today

The state of derivative suits today presents a multi-faceted tableau. Whereas securities class action lawsuits generate considerable attention and outlandish settlements, derivative suits languish, largely ignored by the media and the academic world.³⁷ Scholars point to a variety of factors as the cause of the derivative suit's perceived decline as a method of corporate reform—a formidable demand requirement, the proliferation of state exculpatory statutes, and the growth of a variety of alternative enforcement mechanisms to promote sound corporate

³² Dykstra, "The Revival of the Derivative Suit," 116 U. Pa. L. Rev. 74 (1967).

³³ *Id.*, 116 U. Pa. L. Rev. at 74, 75.

³⁴ *Burks v. Lasker*, 441 U.S. 471, 99 S.Ct. 1831, 60 L.Ed.2d 404 (1979).

³⁵ *Auerbach v. Bennett*, 47 N.Y.2d 619, 419 N.Y.S.2d 920, 393 N.E.2d 994 (1979). This decision and the topic with which it deals are discussed at length in Chapter 8 *infra*.

³⁶ Coffee and Schwartz, "The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform," 81 Colum. L. Rev. 261 (1981).

³⁷ LaCroix, "Do Derivative Suits Still Matter?" *The D&O Diary* (Nov. 27, 2007), available at <http://www.dandodiary.com/2007/11/articles/shareholders-derivative-litiga/do-derivative-lawsuits-still-matter/> (last visited April 17, 2008).

governance.³⁸ Such perception, however, may not equal reality; recent studies indicate that these hurdles have merely refined the derivative claim's role, and anecdotal evidence even indicates the possibility of a resurgence of derivative suit activity.

Following the Supreme Court's 1979 decision in *Burks v. Lasker* that a state law permitting an independent minority of the board to dismiss a complaint against the majority directors did not violate the federal regulatory scheme, several key cases strengthened the demand requirement, thereby increasing the shareholder's burden in bringing a derivative claim.³⁹ The Delaware case of *Zapata Corporation v. Maldonado* examined the justification underlying the requirement that a shareholder make a demand upon the board prior to filing a derivative suit.⁴⁰ The *Zapata* court concluded that the demand obligation serves as a procedural mechanism to promote adherence to the legal principle that a board's business decisions should be insulated from judicial interference. This decision was in marked contrast to the theory, then espoused by a number of courts, that the demand requirement arose from a simple obligation to exhaust all other remedies available to the corporation before bringing suit; under this theory, even if a board refused the demand, the shareholder could bring suit on his own.⁴¹

In 1984, *Aronson v. Lewis* further strengthened the standard required to prove demand futility.⁴² Under *Aronson*, to prevail on a claim of demand futility, plaintiff must allege in the complaint "particularized facts" creating a reasonable doubt that "(1) the directors are disinterested and independent and (2) that the challenged transaction was otherwise the product of a valid exercise of business judgment."⁴³ This standard substantially increased plaintiff's burden in alleging demand futility because such allegations must be made without the benefit of discovery.⁴⁴

³⁸ Davis, "The Forgotten Derivative Suit," University of Wisconsin Law School, Legal Studies Research Paper Series Paper No. 1055 (2007), available at <http://ssn.com/abstract=1031755> (last visited April 17, 2008).

³⁹ *Burks v. Lasker*, 441 U.S. 471, 99 S.Ct. 1831, 60 L.Ed.2d 404 (1979).

⁴⁰ *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981) (discussed in Davis, N. 38 *supra* at 17, 18).

⁴¹ Davis, *id.* at 17, 18.

⁴² *Id.* at 19; see also, *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984), *rev'd on other grounds by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

⁴³ *Aronson v. Lewis*, *id.* (discussed in Davis, "The Forgotten Derivative Suit," at 17, 18, University of Wisconsin Law School, Legal Studies Research Paper Series Paper No. 1055 (2007), available at <http://ssn.com/abstract=1031755> (last visited April 17, 2008)).

⁴⁴ Davis, *id.* at 19.

In addition to the discouraging enhanced demand requirement, alternative enforcement measures and state exculpatory statutes have also reduced incentives to bring derivative claims. SEC enforcement actions and criminal prosecutions for white-collar crimes have multiplied since the days of *Burks v. Lasker*, confronting malfeasant directors with a variety of potential civil and criminal penalties.⁴⁵ The increased SEC activity has compensated for the enhanced demand requirement in derivative suits by providing an arguably more efficient alternative to shareholder derivative suits as a tool for policing corporate governance.⁴⁶ Shareholders now have a reduced incentive to bring derivative suits since they can rely on the SEC's substitute enforcement expertise and resources.⁴⁷

The proliferation of state exculpatory statutes has also contributed to the decline of the derivative suit, although indirectly.⁴⁸ By statutorily shielding directors from certain types of liability, the exculpatory statutes have increased the likelihood that the board or special litigation committee will not determine that filing suit is in the company's best interests. These exculpatory statutes not only effectively limit the board's ability to find that a particular director has acted wrongfully, they also negate the possibility of obtaining monetary compensation from that director for any conduct covered by the exculpatory provisions. Both factors decrease the potential for a suit to be successful or lucrative, and so correspondingly lower the board's interest in bringing suit.⁴⁹

In spite of these additional hurdles, however, the derivative suit retains a critical role in regulating corporate governance. Derivative claims remain powerful under particular circumstances—in cases involving allegations of self- or inter-company dealing, particularly among those corporations with less frequently traded stock, or where the plaintiffs own a significant interest in the corporation.⁵⁰

In such circumstances, the prerequisites to bringing a derivative claim are more easily met. For example, allegations of self- and inter-company dealing implicate specific concerns that the board of directors is not disinterested or independent, thus aiding the plaintiffs in

⁴⁵ *Id.* at 43.

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ Davis, "The Forgotten Derivative Suit," at 27, 28, University of Wisconsin Law School, Legal Studies Research Paper Series Paper No. 1055 (2007), available at <http://ssn.com/abstract=1031755> (last visited April 17, 2008).

⁴⁹ *Id.*

⁵⁰ See Davis, N. 48 *supra*, at 96, 97, where reported decisions in cases asserting derivative claims against Delaware corporations from 2000 to 2007 were analyzed.

proving demand futility. And where the shareholder who brings suit already owns a substantial interest in the corporation, that shareholder is more likely to have access to the facts needed to state his claim for demand futility with particularity. At the same time, smaller or privately held corporations lack the frequent trading activity that allows the SEC and other government agencies to monitor a corporation's behavior, arguably leaving the derivative suit as a more effective enforcement mechanism.

Moreover, anecdotal evidence in recent years suggests that derivative suits may be increasing in circumstances other than those just described.⁵¹ The growing number of Foreign Corrupt Practices Act ("FCPA") derivative suits provides one example of this. Although the FCPA does not provide for a private right of action, companies, directors and officers under investigation by the DOJ and SEC are increasingly finding themselves enmeshed in collateral civil litigation, including shareholder derivative suits.⁵² The rising incidence of these

⁵¹ Creswell, "One Route Seems Closed, So Lawyers Try Different Lawsuit in Stock-Option Scandal," *New York Times* (Sept. 5, 2006); Simmons and Ryan, "Securities Class Action Settlements 2006 Review and Analysis," Cornerstone Research (2006).

⁵² See, e.g.:

First Circuit: *Grynberg v. BG Group P.L.C.*, 1:09-cv-10543-NG (D. Mass. 2009). On April 8, 2009, a shareholder filed a derivative action in the U.S. District Court for the District of Massachusetts against BG Group P.L.C.'s current directors, alleging that BG Group participated in a consortium of large oil companies that made illegal payments to Kazakh officials to secure oil and gas drilling concessions in violation of the FCPA and other laws. The lawsuit was voluntarily dismissed on August 25, 2009.

Fifth Circuit: *Sheetmetal Workers' National Pension Fund v. Deaton*, 4:07-cv-01517 (S.D. Tex. 2007). On May 26, 2009, the U.S. District Court for the Southern District of Texas, Houston Division, dismissed a derivative claim filed by the Midwestern Teamster Pension Trust Fund, on behalf of Baker Hughes, Inc., against twenty-five past and present directors and officers. Plaintiff-shareholders allege that the directors breached their fiduciary duties by not ensuring adequate internal controls over Baker Hughes's FCPA compliance. The court held that plaintiffs failed to show that a majority of the board could not impartially consider a demand to bring the action. Accordingly, the court dismissed the claim because of the plaintiffs' failure to make an initial demand on the board.

Ninth Circuit: *In re UTStarcom, Inc. Securities Litigation*, 5:04-cv-04908-JW (N.D. Cal. 2004). In the pending securities fraud action, the plaintiff-shareholders allege that UTStarcom knowingly violated the FCPA by bribing officials in China, Mongolia and India to secure contracts, which forced the company to restate its financial results and led to joint DOJ/SEC investigations. In March 2009, the U.S. District Court for the Northern District of California denied the defendants' motion to dismiss the plaintiffs' fourth amended complaint.

Eleventh Circuit: *Alverson v. Caldwell*, 6 :08-cv-00045-ACC-DAB (M.D. Fla. 2008). In April 2009, FARO Technologies Inc. settled a shareholder derivative lawsuit alleging that its officers and directors breached their fiduciary duties by failing to properly oversee the company's internal activities. Among the numerous claims

collateral civil suits indicates the increasing liability exposure for the directors and officers of public companies and their insurers. The wave of stock options backdating scandals provoked a resurgence in the number of derivative suits filed, overshadowing the number of direct class actions brought against those companies.⁵³ Similarly, the current subprime litigation has spawned a proliferation of derivative suits.⁵⁴ Although it is presently unclear why the number of derivative suits has increased so substantially in relation to class action lawsuits, one likely factor is the requirement that a plaintiff must allege loss to the company's shareholders prior to filing a federal class action lawsuit, whereas misconduct characterized by backdated allegations need not always be accompanied by a notable decrease in share price.

Another reason may be several recent substantial settlements in derivative suits.⁵⁵ In contrast to historical derivative settlements, which generated smaller sums and were centered on provisions for corporate governance reform, several new cases have proven more lucrative for plaintiffs and their lawyers. For example, a derivative suit against Hollinger International resulted in a \$50 million settlement,⁵⁶ and the settlement of derivative claims against Oracle included a \$100 million payment to charity, as well as \$22 million in attorney's fees.⁵⁷ Furthermore, securities class actions involving companion derivative actions tend to be associated with significantly higher settlement

made, the plaintiff-shareholders alleged that FARO materially overstated its financial results by artificially inflating the value of its sales as a result of the unlawful payments made in connection with foreign sales activities in China.

State Court:

Texas: *Policemen and Firemen Retirement System of City of Detroit v. Cornelison*, No. 2009-29987 (Tex. Dist. Ct. 2009). Following the settlement of FCPA claims with the DOJ and SEC, a derivative lawsuit was brought against a number of present and past directors of Halliburton and KBR in Texas state court. Among other claims, the complaint alleges that the defendants breached their fiduciary duties by failing to oversee the companies' operations, citing the FCPA settlement.

⁵³ LaCroix, "Don't Forget About Options Backdating," *The D&O Diary* (Feb. 10, 2008), available at <http://www.dandodiary.com/2008/02/articles/options-backdating/dont-forget-about-options-backdating/> (last visited April 17, 2008).

⁵⁴ LaCroix, "Subprime-Related Derivative Lawsuits: The List," *The D&O Diary* (April 8, 2008), available at <http://www.dandodiary.com/2008/04/articles/subprime-litigation/subprimerelated-derivative-lawsuits-the-list/> (last visited April 17, 2008).

⁵⁵ LaCroix, "Yes, But WHY Are They Filing Derivative Suits?," *The D&O Diary* (Sept. 11, 2008), available at <http://www.dandodiary.com/2006/09/articles/options-backdating/yes-but-why-are-they-filing-derivative-suits/> (last visited April 17, 2008).

⁵⁶ *Seventh Circuit: Securities and Exchange Commission v. Black*, 2005 U.S. Dist. LEXIS 12884 (N.D. Ill. June 17, 2005).

State Court:

Delaware: Hollinger International, Inc. v. Black, 844 A.2d 1022 (Del. Ch. 2004), *aff'd* 872 A.2d 559 (Del. 2005).

⁵⁷ *In re Oracle Cases*, No. 4180 (Cal. Super., San Mateo Cy., Sept. 22, 2005).

amounts, especially in recent years.⁵⁸ Whatever the rationale for this new spate of derivative litigation, the trend serves only to emphasize that although derivative suits may be subject to more restrictions than in previous years, they remain a critical piece of the U.S. corporate governance legal regime.

⁵⁸ Ryan & Simmons, *Securities Class Action Settlements: 2011 Review and Analysis*, 13, available at http://securities.stanford.edu/Settlements/REVIEW_1995-2011/Settlements_Through_12_2011.pdf.

§ 1.04 Statutes Affecting Derivative Lawsuits

Since 1995, various statutes have been enacted that have altered the landscape for derivative lawsuits. None of these statutes had the stated intent of reforming derivative litigation in the United States. However, all of them have resulted in changes to how derivative cases are litigated. We discuss these statutory schemes in turn.

[1]—The Private Securities Litigation Reform Act

On December 22, 1995, the Private Securities Litigation Reform Act (The “Reform Act”) became law.¹ The Reform Act was passed to remedy perceived abuses in the securities litigation process and is perhaps the most sweeping securities reform in decades.²

The Reform Act is, by its terms, drafted to impact securities class action litigation, but its sweep will likely be felt in the complementary area of shareholder derivative litigation. Indeed, one might even speculate that as bringing class actions is made more difficult, aggrieved shareholders might seek to avail themselves of procedures afforded through derivative actions with increased frequency.³ In fact, in the years immediately following the enactment of the Reform Act, the number of securities class actions filed in state courts increased dramatically.⁴ Although the number of class action filings has evened out in more recent years,⁵ it is still appropriate to consider the significant changes brought forth by the Reform Act and the possible impact they may have on shareholder derivative proceedings.

¹ President Clinton vetoed the Reform Act on December 19, 1995. On December 20, 1995, the House of Representatives overrode the veto by a vote of 319 to 100. On December 22, 1995, the Senate overrode the presidential veto by a vote of 68 to 30. Accordingly, the Reform Act became law on December 22, 1995. See Pub. L. No. 104-67, 109 Stat. 737.

² The Reform Act’s importance is equaled by that of the Sarbanes-Oxley Act, enacted in 2002 and discussed in § 1.04[4] *infra*. For selected provisions of the Sarbanes-Oxley Act, see Appendix H *infra*.

³ See Starkman, “Directors Gain Power to Bar Certain Shareholders Suits,” Wall Street Journal at B9 (April 28, 1997) (“Observers say shareholders have been filing derivative claims in state court to avoid the restrictions of the 1995 [Reform Act] law.”).

⁴ See Securities Class Action Clearinghouse, Index of Filings, accessed October 22, 2012, available at <http://securities.stanford.edu/companies.html>. See also, United States Securities and Exchange Commission’s Report to the President and Congress on the First Year of the Practice Under the Private Securities Litigation Reform Act of 1995, at 2 (April 1997). It was this concern over increased securities fraud suits in state courts, in an attempt to circumvent the procedural hurdles imposed by the Reform Act, that led to the passage of the Securities Litigation Uniform Standards Act (“SLUSA”) of 1998. The SLUSA is discussed in detail in § 1.04[2] *infra*.

⁵ See Securities Class Action Clearinghouse, *Securities Class Action Filings: 2012 Mid-Year Assessment*, available at http://securities.stanford.edu/clearinghouse_research/2012_YIR/Cornerstone_Research_Securities_Class_Action_Filings_2012_MYR.pdf. The

[a]—Purposes of the Reform Act

The Conference Report that accompanied the Reform Act made clear that the intent of the legislature was to curtail the filing of what Congress believed were “abusive” and “frivolous” securities lawsuits.⁶ In particular, the Conference Report articulated the purposes behind the legislation as follows:

“Congress has been prompted by significant evidence of abuse in private securities lawsuits to enact reforms to protect investors and maintain confidence in our capital markets. The House and Senate Committees heard evidence that abusive practices committed in private securities litigation include: (1) the routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer’s stock price, without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might eventually lead to some plausible cause of action; (2) the targeting of deep pocket defendants, including accountants, underwriters, and individuals who may be covered by insurance, without regard to their actual culpability; (3) the abuse of the discovery process to impose costs so burdensome that it is often economical for the victimized party to settle; and (4) the manipulation by class action lawyers of the clients whom they purportedly represent.”⁷

By its terms, the Reform Act was written to curb these perceived abuses. The debate that raged in the two houses of Congress and between Congress and the White House was whether the provisions were sufficiently tailored to ferret out abusive lawsuits without deterring meritorious claims. Indeed, in his veto message President Clinton stated: “I ask Congress to send me a bill promptly that will put an end to litigation abuses while still protecting the legitimate rights of ordinary investors. I will sign such a bill as soon as it reaches my desk.”⁸

[b]—Provisions of the Reform Act

The Reform Act was divided into three titles: Reduction of Abusive Litigation (Title I), Reduction of Coercive Settlement (Title II), and Auditor Disclosure of Corporate Fraud (Title III). The highlights of each Title are discussed below.

all-time high of securities filings post-PSLRA was 497 in 2001. By 2011, this number dropped to 188 federal securities class actions, a slight increase from the 176 filed in 2010.

⁶ H.R. Conf. Rep. No. 369, 104th Cong., 1st Sess. (1995), 141 Cong. Rec. H13692 at H13699-H13700 (1995) (hereinafter, “Conference Report”).

⁷ *Id.* at H13699.

⁸ President’s Veto Message, December 19, 1995.

[i]—Reduction of Abusive Litigation

Of particular significance, Title I of the Reform Act (1) amended the processes of conducting private securities actions; (2) created a safe harbor for the making of certain forward-looking statements; and (3) amended the Racketeer Influenced Corrupt Organizations Act (“RICO”) to remove conduct that could be actionable as securities fraud from the definition of predicate acts which can give rise to RICO liability.

Private Securities Litigation Reform. In order to effect private securities litigation reform, the Reform Act amended both the Securities Act of 1933 (the “Securities Act”) and the Securities and Exchange Act of 1934 (the “Exchange Act”) by adding parallel new sections to each statute.⁹ Accordingly, the changes discussed below relate only to actions commenced under either the Securities Act or the Exchange Act and not to other provisions of the federal securities laws, other federal statutes, state statutes, or the common law.

The new sections were largely directed at the conduct of plaintiffs and their attorneys in private securities actions. In particular, these provisions are intended to reduce the incidence of “professional plaintiffs” and to reduce the number of lawsuits provoked by attorneys. As noted by the Conference Report:

“These provisions are intended to encourage the most capable representatives to the plaintiff class to participate in class action litigation and to exercise supervisions and control of the lawyers for the class.”¹⁰

First, the Reform Act requires each plaintiff to file a certification with his or her complaint (1) indicating that the plaintiff has authorized the filing of the lawsuit; (2) stating that the plaintiff did not purchase the securities upon which he or she is suing at the directions of counsel or in order to be able to participate in the lawsuit¹¹; (3) indicating that the plaintiff is willing to serve as a class representative (providing testimony at a deposition or at trial, if necessary); (4) setting forth all the transactions of the plaintiff in the security that is the subject of the action; (5) setting forth all other actions during the preceding three years in which the plaintiff sought to act or acted in a representative capacity; and (6) indicating that the plaintiff will not accept any fee for serving in a representative capacity other than the

⁹ The Securities Act was amended through the addition of Section 27, and the Exchange Act was amended through the addition of Section 21D.

¹⁰ Conference Report, N. 6 *supra*, at H13700.

¹¹ This requirement can be seen as analogous to the contemporaneous ownership requirement in shareholder derivative proceedings. For a description of the contemporaneous ownership requirements, see § 4.02 *infra*.

plaintiff's *pro rata* share of the recovery and any expenses that the plaintiff reasonably incurred.¹²

Second, the Reform Act attempted to limit the incentive for plaintiffs' attorneys to "race to the court house." That is, legislators noted the tendency of plaintiffs' attorneys to attempt to be the first to file a complaint, believing that the first to file would be allowed to represent the class. In the words of the legislators, the race "caused plaintiffs' attorneys to become fleet of foot and slight of hand," filing complaints in too hasty a fashion.¹³ The legislation therefore put in place a new procedure for the selection of the representative plaintiff, denominated in legislative parlance as the "most adequate plaintiff," and class counsel.

Under the Reform Act, the plaintiff who filed the action is required to publish a notice in a widely circulated business publication within twenty days after the filing of the complaint. The notice must indicate that the action has been filed and must advise purported class members that they have sixty days within which to request the appointment of an interested class member as class representative. Not later than ninety days after the complaint is filed, the court in which the action was filed is required to select the class representative who the court believes is the most capable to serve the interests of the class.¹⁴ The Reform Act requires the court to adopt a rebuttable presumption that the most adequate plaintiff is the person with the largest financial interest in the relief sought by the class.¹⁵ The lead plaintiff is then afforded the right to select and retain counsel subject to approval by the court.

Courts disagree over whether the presumption that the most adequate plaintiff is the person with the largest financial interest raises the standard for adequacy. In *Berger v. Compaq Computer Corp.*,¹⁶ the Fifth Circuit claimed that the standard was raised to require that courts select the most sophisticated investor available. The Ninth

¹² Under the Reform Act, a plaintiff is entitled to recover reasonable costs and expenses (including lost wages) directly relating to the representation of the class. See Reform Act § 101(a)(4).

¹³ Conference Report, N. 6 *supra*, at H13700.

¹⁴ Reform Act §§ 101(a)(3)(A) and 101(a)(3)(B).

¹⁵ Reform Act § 101(a)(3)(B)(iii)(I). The presumption can be rebutted only upon proof that the presumptively most adequate plaintiff will not fairly and adequately represent the interests of the class or is subject to unique defenses that render such plaintiff incapable of adequately representing the class. Reform Act § 101(a)(3)(B)(ii)(II). Discovery regarding the adequacy of a plaintiff may be conducted by another would-be plaintiff only if that person first demonstrates a reasonable basis for finding that the presumptively most adequate plaintiff is incapable of representing the class. Reform Act § 101(a)(3)(B)(iv).

¹⁶ *Berger v. Compaq Computer Corp.*, 257 F.3d 475, 483 (2001), *reh'g denied* 279 F.3d 313 (5th Cir. 2002).

Circuit disagreed. In *In re Cavanaugh*¹⁷ the Ninth Circuit held that while the Reform Act created a presumption that the lead plaintiff is the one with the greatest financial stake, the requirements of adequacy and typicality, which are to be applied after the plaintiff with the greatest financial stake is selected, remain the same.¹⁸

Third, the Reform Act limits the amount of attorneys' fees and expenses that can be awarded to plaintiffs' counsel. Specifically, plaintiffs' attorneys may not obtain a recovery that exceeds a reasonable percentage of the amount of damages and prejudgment interest actually paid to the class.¹⁹ This was not, however, meant as a rejection of the lodestar method of calculating fees.²⁰ Rather, the provision focuses on the award as a percentage of the recovery and not on the method of calculation.²¹

The Ninth Circuit has held that the limit imposed by the Reform Act on the amount of attorneys' fees and expenses is not to be applied in selecting the lead plaintiff.²² According to the court, the focus in selecting a particular plaintiff is on the plaintiff's adequacy and typicality, not on the attorneys plaintiff has selected, and that information on plaintiff's selection of counsel is "relevant only to determine

¹⁷ *In re Cavanaugh*, 306 F.3d 726, 736 (9th Cir. 2002) ("We conclude, therefore, that the Reform Act did not change the standard for adequacy, and that the adequacy inquiry remains the same in determining the lead plaintiff in securities cases as in determining the class representative in other cases brought under Rule 23.").

¹⁸ When determining whether a party possessed the "largest financial interest," one must consider the total number of shares purchased, the number of net shares purchased, the total net funds spent during the class period, and the total losses suffered. See:

Ninth Circuit: *In re Network Associates, Inc. Securities Litigation*, 76 F. Supp.2d 1017 (N.D. Cal. 1999), the Court quoted a memorandum submitted by the Securities and Exchange Commission in *In re Oxford Health Plans, Inc.*, 182 F.R.D. 42 (S.D.N.Y. 1998), commenting that the "'language and purpose of the Act make clear that Congress believed that the compensation and protection of investors would best be served if only one lead plaintiff, that with the largest financial interest in the litigation, were to be appointed.'" *Network Associates, id.*, 76 F. Supp.2d at 1025.

Eleventh Circuit: *Burke v. Ruttenberg*, 102 F. Supp.2d 1280, 1341-1344 (N.D. Ala. 2000). (Citation omitted.)

¹⁹ Reform Act § 101(a)(4).

²⁰ Simply stated, the lodestar method of fee calculation takes the number of hours worked by the plaintiffs' attorney, multiplies it by a reasonable hourly rate and, under appropriate circumstances, increases the total by an additional multiplier to account for the degree of difficulty of the case or the risk involved in conducting the litigation.

²¹ See H.R. Conf. Rep. No. 369, 104th Cong., 1st Sess. (1995), 141 Cong. Rec. H13692 at H13701 (1995) (hereinafter "Conference Report").

²² *In re Cavanaugh*, N. 17 *supra*. The court overturned a decision of the lower court that approved a self-employed investor as lead plaintiff, rather than a group of businessmen, based upon his showing of a significant difference in potential attorneys' fees.

whether the presumptive lead plaintiff's choice of counsel is so irrational, or so tainted by self-dealing or conflict of interest, as to cast genuine and serious doubt on that plaintiff's willingness or ability to perform the functions of lead plaintiff."²³

Fourth, the Reform Act amends the information that must be disclosed to members of the class as part of the notice of any proposed settlement of an action commenced under the Securities Act or the Exchange Act.²⁴ In adopting this provision, Congress was reacting to the perceived need to afford class members with notice that they could readily understand and which provided them with sufficient information to make an informed decision as to whether to participate in any proposed settlement.²⁵ It is well established, however, that settlements are binding on absent class members so long as the notice program is procedurally adequate, even if the absent class members do not receive personal written notice.²⁶

To assure clear and understandable disclosure, the settlement notice is required to include the following information: (1) the recovery to be afforded the plaintiff class in the aggregate and on a per share basis; (2) the amount of damage that would be recoverable by the plaintiffs on a per share basis if the matter were not settled, provided that if the parties cannot agree on such an amount that each party includes his or her own estimate; (3) the amount of attorneys' fees and costs sought by the plaintiffs' attorneys; (4) the name, address and telephone number of one or more of the plaintiff's attorneys who will be available to answer questions; and (5) the reasons why the parties are proposing the settlement. The notice must also contain a summary of each of these items on the cover page.²⁷

Finally, the Reform Act increases the specificity by which plaintiffs must plead Securities fraud claims arising under the Securities Act and the Exchange Act.²⁸ This heightened pleading standard puts

²³ *Id.*, 306 F.3d at 732-733.

²⁴ The Reform Act also prohibits a court from sealing the terms and provisions of a settlement of claims made pursuant to the Securities Act or the Exchange Act, unless a party is able to demonstrate good cause for so doing. Good cause can be established only by showing that failure to place the matter under seal would cause direct and substantial harm to any party. Reform Act § 101(a)(5).

²⁵ Conference Report, N. 21 *supra*, at H13701.

²⁶ *In re Nasdaq Market-Makers*, 1999 WL 395407, at *2 (S.D.N.Y. June 15, 1999).

²⁷ Reform Act § 101(a)(7). See, e.g., *In re Prudential Securities, Inc. Ltd. Partnership Litigation*, 947 F. Supp. 750, 755-756 (S.D.N.Y. 1996) (holding that publication twice in three newspapers of national circulation and mailing to 274,000 prospective class members constituted adequate notice).

²⁸ The goal of this specificity requirement is to discourage frivolous securities litigation. The Eighth Circuit in *Green v. Ameritrade*, 279 F.3d 590, 595 (8th Cir. 2002), articulated this goal by providing that "the PSLRA . . . was designed to curb abuse

potential plaintiffs on notice that insufficiently supported allegations will not survive the pleadings stage.²⁹

In particular, the Reform Act imposes three distinct pleading requirements on plaintiffs alleging securities fraud, and recent decisions have outlined what plaintiffs must allege to survive a motion to dismiss pursuant to these pleading requirements. Although the Circuits have disagreed regarding the weight of plaintiffs' burden, recent decisions have clarified the PSLRA's requirements, and have concluded that the Reform Act standard imposes a higher burden than that imposed by traditional rules governing allegations of securities fraud.³⁰

First, plaintiffs must specify each statement alleged to have been misleading and the reason(s) why the statement is misleading.³¹ This provision makes explicit the pleading requirements that courts previously construed were implied by Rule 9(b)³² of the Federal Rules of Civil Procedure,³³ and has been held to be coextensive with the prior standard set forth in Rule 9(b).³⁴

Second, if an allegation regarding a statement or omission is made on information and belief, the complaint must state with particularity all facts on which that belief is formed.³⁵ Litigation under this provision has focused on whether a plaintiff can survive a motion to dismiss without naming the confidential source(s) supplying the facts

in securities suits, particularly shareholder derivative suits in which the only goal was a windfall of attorney's fees, with no real desire to assist the corporation on whose behalf the suit was brought."

²⁹ *Id.*, 279 F.3d at 595 (quoting *In re Lutheran Brotherhood Variable Insurance Products Co. Sales Practices Litigation*, 105 F. Supp.2d 1037, 1039 (D. Minn. 2000)). See also, *City of Philadelphia v. Fleming Cos.*, 264 F.3d 1245, 1258 (10th Cir. 2001) ("The enactment of the PSLRA in 1995 marked a bipartisan effort to curb abuse in private securities lawsuits, particularly the filing of strike suits.") (quoting *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 191 (1st Cir. 1999)). A strike suit is any suit—especially a shareholder derivative suit—brought for nuisance value or as leverage to obtain an inflated settlement. See *Black's Law Dictionary* 1448 (6th ed. 1999).

³⁰ See Fed. R. Civ. P. 9(b). See also, *In re Rockefeller Center Properties, Inc.*, 311 F.3d 198, 217 (3d Cir. 2002) (finding that Reform Act imposes another layer of factual particularity to allegations of securities fraud extending that of Rule 9(b)).

³¹ Reform Act § 101(b)(1).

³² Fed. R. Civ. P. 9(b) ("In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity.").

³³ See, e.g.:

Second Circuit: *Mills v. Polar Molecular Corp.*, 12 F.3d 1170, 1175 (2d Cir. 1993) (under Rule 9(b) a plaintiff must specify the statements that the plaintiff contends were fraudulent, identify the speaker, state where and when the statements were made, and explain why the statements were fraudulent).

Fifth Circuit: *Williams v. WMX Technologies, Inc.*, 112 F.3d 175, 177-178 (5th Cir.), *cert. denied* 522 U.S. 966 (1997).

³⁴ See, e.g., *ABC Arbitrage Plaintiffs Group v. Tchuruk*, 291 F.3d 336, 349-350 (5th Cir. 2002) (this provision of the Reform Act "appears to comport with this Court's relatively strict interpretation of Rule 9(b)").

behind the allegations contained in the complaint. Prior to the decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*,³⁶ which will be discussed later in greater depth, the courts that have considered this issue have universally adopted the standard articulated by the Second Circuit in *Novak v. Kasaks*.³⁷ In *Novak* the court held that although the Reform Act may compel revelation of confidential sources under certain circumstances, as a general matter the sources need not be named:

“[W]here plaintiffs rely on confidential personal sources but also on other facts, they need not name their sources as long as the latter facts provide an adequate basis for believing that the defendants’ statements were false. Moreover, even if personal sources must be identified, there is no requirement that they be named, provided they are described in the complaint with sufficient particularity to support the probability that a person in the position occupied by the source would possess the information alleged.”³⁸

Although the *Tellabs* decision³⁹ did not explicitly consider this issue, at least one Seventh Circuit case has interpreted the decision as requiring the court to discount allegations attributed to confidential witnesses.⁴⁰ The Seventh Circuit determined that “anonymity conceals

³⁵ Reform Act § 101(b)(1).

³⁶ *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 127 S.Ct. 2499, 168 L.Ed.2d 179 (2007).

³⁷ *Novak v. Kasaks*, 216 F.3d 300, 312-314 (2d Cir. 2000).

³⁸ *Id.*, 216 F.3d at 314. See also:

First Circuit: In re Cabletron Systems, Inc., 311 F.3d 11, 28 (1st Cir. 2002) (“[W]e hold that in the context of the [Reform Act] such confidential source allegations must comply with the standard described below, drawn from the Second Circuit’s *Novak* decision.”).

Third Circuit: California Public Employees’ Retirement System v. Chubb, 394 F.3d 126, 146 (3d Cir. 2004) (“We join the Second Circuit and adopt this standard as the appropriate standard for courts to employ when assessing the sufficiency of allegations made on information and belief.”).

Fifth Circuit: ABC Arbitrage Plaintiffs Group v. Tchuruk, 291 F.3d 336, 351 (5th Cir. 2002) (“Turning, then, to the standard governing the information and belief pleading requirements under [the Reform Act], we find persuasive the Second Circuit’s interpretation of these requirements in *Novak*.”).

Ninth Circuit: In re Daou Systems, Inc., Securities Litigation, 411 F.3d 1006, 1015 (9th Cir. 2005), cert. denied 546 U.S. 1172 (2006) (adopting *Novak* standard).

Tenth Circuit: Adams v. Kinder-Morgan, Inc., 340 F.3d 1083, 1099 (10th Cir. 2003) (“We adopt an approach similar to the Second Circuit’s in *Novak*.”).

Eleventh Circuit: In re PSS World Medical, Inc. Securities Litigation, 250 F. Supp.2d 1335, 1343-1344 (M.D. Fla. 2002) (adopting *Novak* standard).

³⁹ *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 127 S.Ct. 2499, 168 L.Ed.2d 179 (2007).

⁴⁰ *Higginbotham v. Baxter International Inc.*, 495 F.3d 753 (7th Cir. 2007).

information that is essential to the sort of comparative evaluation required by *Tellabs*.⁴¹ It remains to be seen whether the Seventh Circuit's analysis will prove widely convincing.

Finally, in any action in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint must state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind with respect to each alleged act or omission.⁴²

The Circuits are split along three lines regarding what a plaintiff must state to plead adequately *scienter* under the Reform Act.⁴³ The *Tellabs* decision addressed these conflicting standards, and has explicitly disclaimed the Seventh Circuit's more lenient approach.⁴⁴

⁴¹ *Id.*, 495 F.3d at 757.

⁴² Reform Act § 101(b)(2).

⁴³ The Second and Third Circuits adopted their standard from pre-PSLRA *scienter* case law and required plaintiffs to plead either: (1) motive and opportunity to commit fraud or (2) strong circumstantial evidence of recklessness or conscious misbehavior. See:

Second Circuit: Novak v. Kasaks, 216 F.3d 300, 309-310 (2d Cir. 2000).

Third Circuit: In re Advanta Corp. Securities Litigation, 180 F.3d 525, 534-535 (3d Cir. 1999).

The Ninth Circuit adhered to a more stringent pleading standard stating that facts establishing motive and opportunity alone cannot establish strong inference of *scienter*. See In re Silicon Graphics Inc. Securities Litigation, 183 F.3d 970, 974 (9th Cir. 1999). Rather, plaintiffs must state facts that come closer to demonstrating intent. *Id.* The Ninth Circuit also was alone in holding that a showing of mere recklessness was insufficient to meet the pleading standard. *Id.* See also, In re Daou Systems, Inc., Securities Litigation, 411 F.3d 1006 (9th Cir. 2005), *cert. denied* 546 U.S. 1172 (2006).

The remaining circuits adopted a variety of intermediate standards, some holding that only a portion of the Second Circuit's standard was embodied in the PSLRA's codification, and some holding that the Second Circuit's standard was merely one method of testing the sufficiency of a claim. See, e.g.:

First Circuit: In re Cabletron Systems, Inc., 311 F.3d 11 (1st Cir. 2002). *Fourth Circuit*: Ottmann v. Hanger Orthopedic Group, Inc., 353 F.3d 338 (4th Cir. 2003).

Fifth Circuit: Nathenson *ex rel.* DSAM Global Value Fund Ltd. v. Zonagen Inc., 267 F.3d 400 (5th Cir. 2001).

Sixth Circuit: Fidel v. Farley, 392 F.3d 220 (6th Cir. 2004).

Seventh Circuit: Makor Issues & Rights, Ltd. v. Tellabs, Inc., 437 F.3d 588 (7th Cir. 2006), *vacated & remanded* 551 U.S. 308, 127 S.Ct. 2499, 168 L.Ed.2d 179 (2007). The Seventh Circuit in particular adopted a lenient approach, permitting a complaint to survive as long as plaintiffs pled facts that, if examined together, would permit a reasonable person to draw a strong inference of *scienter*.

Eighth Circuit: Florida State Board of Administration v. Green Tree Financial Corp., 270 F.3d 645, 660 (8th Cir. 2001).

Tenth Circuit: City of Philadelphia v. Fleming Cos., 264 F.3d 1245 (10th Cir. 2001).

Eleventh Circuit: Bryant v. Dupree, 252 F.3d 1161 (11th Cir. 2001).

⁴⁴ *Tellabs Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 127 S.Ct. 2499, 168 L.Ed.2d 179 (2007). The case examined what a plaintiff is required to plead under the PSLRA in order to establish a "strong inference" that the defendant acted with

Under *Tellabs*, the Supreme Court, describing its task as prescribing “a workable construction of the ‘strong inference’ standard, a reading geared to the PSLRA’s twin goals: to curb frivolous, lawyer-driven litigation, while preserving investors’ ability to recover on meritorious claims,” provided guidance on the standard for assessing whether a plaintiff has pled a strong inference of scienter.⁴⁵

The Court established a three-step evaluation process for lower courts. First, the Court stated that when faced with a motion to dismiss a securities fraud claim, “courts must, as with any motion to dismiss for failure to plead a claim on which relief may be granted, accept all factual allegations in the complaint as true.”⁴⁶ Second, the allegations in the complaint must be assessed “holistically.”⁴⁷ Courts must accept all factual allegations as true and consider the complaint in its entirety, not merely whether one or two allegations, “scrutinized in isolation” meet the strong inference standard.⁴⁸ Finally, when assessing the complaint, courts must perform a balancing test, examining the pleaded facts for both strong inferences of *scienter* and “plausible opposing inferences.”⁴⁹ As the Court explained, the PSLRA requires more than merely a possibility of *scienter*; there must be a strong inference.⁵⁰

The Court emphasized that courts must assess all the allegations “holistically.” Thus it found that the mere absence of insider trading allegations or the existence of “omissions or ambiguities” in the allegations of improper channel-stuffing may “count against inferring scienter,” but

the requisite mental state. The Court’s opinion, written for an 8–1 majority by Justice Ruth Bader Ginsburg, rejected both the Seventh Circuit’s standard (by which the statute’s requirements could be met if the complaint alleged facts “from which, if true, a reasonable person could infer that the defendant acted with the required intent”) and the more demanding standard sought by the SEC in its amicus brief (urging the Court to require plaintiff to allege facts that establish a “high likelihood” that the plaintiff acted with intent).

⁴⁵ *Id.*, 127 S.Ct. at 2509-2511.

⁴⁶ *Id.*, 127 S.Ct. at 2509.

⁴⁷ *Id.*, 127 S.Ct. at 2511.

⁴⁸ *Id.*, 127 S.Ct. at 2509.

⁴⁹ *Id.*, 127 S.Ct. at 2509-2510.

⁵⁰ The Court notes that “[t]he strength of an inference cannot be decided in a vacuum. The inquiry is inherently comparative.” *Tellabs Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 127 S.Ct. 2499, 2510, 168 L.Ed.2d 179 (2007). Moreover,

“To determine whether the plaintiff has alleged facts that give rise to the requisite ‘strong inference’ of scienter, a court must consider plausible nonculpable explanations for the defendant’s conduct, as well as inferences favoring the plaintiff. . . . The inference of scienter must be more than merely ‘reasonable’ or ‘permissible’—it must be cogent and compelling. [*Id.*] A complaint will survive, we hold, only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged.”

Id., 127 S.Ct. at 2510.

they are not, by themselves, dispositive as to whether the plaintiffs had met the “strong inference standard.”⁵¹

Even though the Court rejected the Seventh Circuit’s standard, the Supreme Court’s opinion does not go quite as far as the SEC and others may have hoped. Although the Supreme Court requires the court to weigh inferences, it does not require the inference the plaintiff urges to be the *most plausible* inference, only that it be *at least as plausible* as other inferences.⁵² Moreover, it is important to note that the *Tellabs* decision has not completely resolved all questions of what constitutes *scier* for complaints under the PSLRA. The decision purposefully did not address the additional question of when and whether reckless behavior may constitute *scier*, but has left this decision for another case.⁵³

The Safe Harbor for Forward-Looking Statements. The Reform Act provided a limited statutory safe harbor for forward-looking statements. The debate has long raged as to whether it is better to allow corporations to make forecasts regarding their future performance and risk confusion by shareholders who interpret such predictions as promises. A detailed discussion of this debate is beyond the scope of this work. Suffice it to say that the Reform Act’s attempt to craft an effective safe harbor comes after the considerable debate that has surrounded the matter for some time.⁵⁴

Congress implemented the safe harbor in the Reform Act by amending both the Securities Act and the Exchange Act through the addition of new provisions to these statutes.⁵⁵ In general terms, the Reform Act provides that any of the listed parties (including issuers and certain persons retained or acting on behalf of an issuer) shall not be liable for making forward-looking statements if either (1) the statement is identified as such and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement or (2) the statement is immaterial. The Reform Act further states that a business entity cannot be held liable for a forward-looking statement unless such statement was made by or with the approval

⁵¹ *Id.* at 2511.

⁵² *Id.* at 2513.

⁵³ *Id.* at 2507.

⁵⁴ It should be noted that the safe harbor crafted by Congress is not intended to displace the judicially created “bespeaks caution” doctrine, which has also been provided as a means for corporations to limit their liability for certain forward-looking statements. See H.R. Conf. Rep. No. 369, 104th Cong., 1st Sess. (1995), 141 Cong. Rec. H13692, H13704 (1995) (hereinafter, “Conference Report”).

⁵⁵ The Securities Act was amended to add Section 27A and the Exchange Act was amended to add Section 21E.

of an executive officer of the business entity who had actual knowledge that the statement was false or misleading. An individual cannot be held liable for a forward-looking statement unless that person made such statement with actual knowledge that it was false or misleading.⁵⁶

Amendment to RICO. Prior to the Reform Act, the list of RICO predicate acts—those acts that, if they were conducted by or through an enterprise and formed a pattern, could provide the basis for a civil RICO claim—included fraud in the sale of securities. Attracted by the allure of treble damages, plaintiffs would attempt to establish the requisite pattern of illicit conduct by pleading that a defendant’s conduct regarding a particular set of securities activities amounted to fraud in the sale of securities, mail fraud, and wire fraud.

The Reform Act amended RICO to exclude from the definition of predicate acts any conduct that could have been actionable as fraud in the purchase or sale of securities unless the person against whom the action is commenced has been found criminally liable for fraud in connection with the conduct in question.⁵⁷ Accordingly, this not only will estop a plaintiff from asserting a RICO violation based on the predicate act of fraud in the sale of securities, but will also prevent RICO claims based on mail and wire fraud predicates that have at their root the purported securities fraud.

[ii]—Reduction of Coercive Settlements

In its list of private securities litigation abuses, the Conference Committee included cases involving “the targeting of deep pocket defendants, including accountants, underwriters, and individuals who may be covered by insurance, without regard to their actual culpability.”⁵⁸ The Conference Committee added that “[o]ne of the most manifestly unfair aspects of the current system of securities litigation is its imposition of liability on one party for injury actually caused by another.”⁵⁹ According to the Conference Committee, this “system of joint and several liability creates coercive pressure for entirely innocent parties to settle meritless claims rather than risk exposing themselves to liability for a grossly disproportionate share of damages in the case.”⁶⁰

To eliminate the coercive effect of suits on “deep pocket defendants,” the Reform Act replaces the traditional system of joint and several liability in private actions with a system of proportionate liability for certain “covered” defendants as long as they are not found to have

⁵⁶ Reform Act § 102(c).

⁵⁷ Reform Act § 107.

⁵⁸ Conference Report, N. 54 *supra*, at H13699.

⁵⁹ *Id.* at H13701.

⁶⁰ *Id.*

“knowingly committed a violation of the securities laws.”⁶¹ Section 201 of the Reform Act adds Section 21D(g) to the Exchange Act and amends Section 11(f) of the Securities Act to effect this change.

Absent a finding by a court or a jury that a “covered person” defendant “knowingly” violated the securities laws,⁶² the defendant’s liability is limited to the “percentage of responsibility” attributed to the defendant by the court or jury with limited exceptions in cases where another defendant’s share is uncollectible.⁶³ The Reform Act also provides for a right of contribution in private claims, with a six-month statute of limitation for contribution claims, and for a discharge of liability for settling defendants, with a corresponding reduction in the amount of judgment that plaintiffs may obtain from nonsettling defendants.⁶⁴

[iii]—Auditor Disclosure of Corporate Fraud

Among other things, the adoption of the Reform Act represented an unequivocal expression of congressional support for self-policing in the corporate context.⁶⁵ In particular, Section 301 of the Reform Act serves to underscore the growing regulatory emphasis on self-policing and disclosure by squarely placing upon the shoulders of auditors and directors of public companies the responsibility of detecting certain illegal acts.⁶⁶ As will be discussed in the next section, passage of the Sarbanes-Oxley Act of 2002 indicates that Congress is now moving in a different direction.

The Reform Act amends Section 10 of the Securities Act of 1934⁶⁷ by requiring that audits of public companies include “procedures

⁶¹ Reform Act § 201(a).

⁶² “Covered persons” are defined by the Reform Act to include (1) a defendant in any case arising under the Exchange Act, and (2) a defendant in a case arising under Section 11 of the Securities Act who is an outside director of the issuer whose securities are the subject of the case. Exchange Act § 21D(g)(10)(C). The Reform Act’s definition of “knowingly” specifically excludes recklessness. Exchange Act § 21D(g)(10)(B).

⁶³ Exchange Act §§ 21D(g)(3) to 21D(g)(4). Covered persons remain jointly and severally liable for uncollectible shares in two ways: (1) covered persons are jointly and severally liable for the uncollectible share without limitation if a plaintiff is entitled to damages greater than 10% of the plaintiff’s net worth and that net worth is less than \$200,000; or (2) for all other plaintiffs, covered persons are liable in proportion to the covered person’s percentage of responsibility up to 50% of the covered person’s proportionate share. Exchange Act § 21D(g)(4)(A).

⁶⁴ Exchange Act §§ 21D(g)(5) to 21D(g)(9).

⁶⁵ Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (Dec. 22, 1995).

⁶⁶ See generally: Sidorsky, “Auditor’s Duty to Blow the Whistle Under the Litigation Reform Act,” *New York Law Journal* p. 1 (Feb. 9, 1996); Olson, *Fraud Detection and Disclosure—Private Securities Litigation Reform Act of 1995* (PLI Corp. Law and Practice Handbook Series No. B4-7152 1996).

⁶⁷ 15 U.S.C. §§ 78a *et seq.*

designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts.”⁶⁸ The Reform Act also requires that if the auditor detects or becomes aware of an improper act, he must (1) determine whether it is likely that an illegal act has occurred, (2) determine its possible effect on the financial statements of the corporation, and (3) as soon as practicable, inform the appropriate level of management and assure that the audit committee or board is adequately informed of the illegal act.⁶⁹ The auditor has no duty to inform management and the board if the illegal act is “clearly inconsequential.”

Beyond merely informing management and the board of illegal acts, the Reform Act imposed on auditors an obligation to deliver to the board a report if the auditor concludes that (1) the illegal act has a material effect on the company’s financial statements, (2) the directors and/or management have failed to take “timely and appropriate remedial actions,” and (3) the failure to take remedial action is reasonably expected to cause the auditor to depart from a “standard” report or warrant the auditor’s resignation.⁷⁰ A company whose board receives such a report is then required to notify the SEC within one business day after receipt and to furnish the auditor with a copy of the notice to the SEC.⁷¹ If the auditor does not receive a copy of the notice by the end of the required one-business-day period, he is required to furnish the SEC with a copy of the report not later than the second business day after the auditor made his report to the board.⁷²

If the company fails to notify the SEC of the auditor’s report to the board as required, and the auditor then fails to forward a copy of his or her report directly to the SEC as required, the SEC may institute a cease-and-desist proceeding under Section 21C, and may impose a civil penalty under Section 21B against the auditor and any other person who caused such a violation.⁷³

On March 12, 1997, the SEC adopted rules to implement the auditor reporting requirements.⁷⁴ As the SEC has indicated:

“[T]he rules (i) provide that these reports [by auditors] will be non-public and exempt from disclosure under the Freedom of Information Act to the same extent as the Commission’s investigative

⁶⁸ 15 U.S.C. § 78j-1(a)(1).

⁶⁹ 15 U.S.C. § 78j-1(b)(1).

⁷⁰ 15 U.S.C. § 78j-1(b)(2).

⁷¹ 15 U.S.C. § 78j-1(b)(3).

⁷² *Id.*

⁷³ 15 U.S.C. § 78j-1(d).

⁷⁴ Implementation of Section 10A of the Securities Exchange Act of 1934, Release No. 34-38387, 1997 SEC LEXIS 545 (March 12, 1997).

records, (ii) designate the Commission's Office of the Chief Accountant as the appropriate office to receive the reports, and (iii) set forth the required content of the issuer's notice to the Commission."⁷⁵

In sum, it is clear that the Reform Act places enhanced duties on auditors and directors to disclose illegal acts. One commentator has predicted that this provision will have the effect of "transforming the auditor into more of a watchdog over industry-related regulatory compliance."⁷⁶ By placing greater information in the hands of those ultimately responsible for corporate stewardship, the Reform Act should have the parallel effect of heightening pressure on corporate boards to satisfy their fiduciary and regulatory obligations, while at the same time better enabling boards to meet those duties.⁷⁷

[2]—Securities Litigation Uniform Standards Act (SLUSA) of 1998

On November 3, 1998, President Clinton signed the Securities Litigation Uniform Standards Act ("SLUSA") to prevent plaintiff attorneys from attempting to thwart the PSLRA by filing new securities lawsuits in state as opposed to federal court. It amended Section 16 of the Securities Act of 1933 and Section 24 of the Exchange Act of 1934 to provide that any "covered [securities] class action" filed in state court is preempted and must be removed to federal court. The SLUSA's dual purposes are "prevent[ing] plaintiffs from seeking to evade the protections that Federal law provides against abusive litigation by filing suit in State, rather than in Federal, court" and "implement[ing] a uniform law of securities fraud."⁷⁸

⁷⁵ United States Securities and Exchange Commission's Report to the President and Congress on the First Year of the Practice Under the Private Securities Litigation Reform Act of 1995, at 19 (April 1997).

⁷⁶ *Id.*

⁷⁷ The SEC has revised its auditor independence rules, imposing new obligations on the audit committee in addition to those necessarily stemming from the Reform Act and SEC rules promulgated to implement the Act's auditor reporting requirements. The rules require disclosures in proxy statements filed after February 5, 2001. Specifically, audit committees are required to disclose, among other things, whether they considered the impact of non-audit services provided by auditors in their evaluations of the auditors' independence. The SEC views the provision of non-audit services by a company's independent auditor as a threat to auditor independence that creates an economic incentive that may inappropriately influence the audit. See Revision of the Commission's Auditor Independence Requirements, Release No. 34-43602, 2000 SEC LEXIS 2717 (Nov. 21, 2000). This rule arguably increases the duties of the audit committee and potentially heightens the board's exposure to shareholder derivative litigation.

⁷⁸ Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (Nov. 3, 1998). See Conference Report of the Committee of Conference, H.R. Conf. Rep. No. 803, 105th Cong., 2d Sess. (Oct. 9, 1998).

[3]—Evaluating the Impact of the PSLRA

In the first five years after its enactment, the PSLRA did not appear to have had the intended impact on shareholder class action lawsuits. From 1995 to 1998, the number of lawsuits filed actually increased. The number of securities fraud class actions filed in federal court actually increased from 188 such filings in 1995 to an all-time high of 493 filings in 2001, before decreasing to 216 cases in 2003.⁷⁹ Since 2003, the number of filings has stayed relatively constant, with 188 securities fraud class actions filed in 2011.⁸⁰ Yet even so, companies of all industries and sizes continue to be sued in spite of the PSLRA. Since its enactment, there has been an increase in the number of lawsuits alleging accounting improprieties, to include violations of Generally Accepted Accounting Principles (“GAAP”), with the alleged goal of overstating earnings and revenue to inflate share prices.⁸¹

Despite the rise in the number of the shareholder class action lawsuits since the enactment of the PSLRA, shareholders must still satisfy its heightened pleading requirements.

In *Glazer Capital Management, LP v. Magistri*,⁸² shareholders brought a class action lawsuit against InVision Technologies, Inc. and two of its officers, alleging violations of federal securities laws. Glazer Capital Management, LP’s claim arose after InVision announced that it had entered into a merger agreement with General Electric. Several months later, in July 2004, InVision issued a press release, stating uncertainty about the merger because of the discovery of potential violations of the Foreign Corrupt Practices Act of 1997 (“FCPA”).⁸³ An immediate decline in InVision’s stock price followed the announcement.⁸⁴ A few days after InVision’s press release, shareholders filed a class action complaint in the United States District Court for the Northern District of California, identifying three alleged misstatements in the merger agreement in violation of Section 10(b) of the Securities and Exchange Act of 1934 and Rule 10b-5.⁸⁵

In January 2006, the district court granted InVision’s motion to dismiss the complaint but allowed Glazer leave to amend its complaint.

⁷⁹ See *Stanford Law School Securities Class Action Clearinghouse*, available at <http://securities.stanford.edu>.

⁸⁰ *Id.*

⁸¹ See generally, PriceWaterhouseCoopers LLP, *2000 Securities Litigation Study* (2000).

⁸² *Glazer Capital Management, LP v. Magistri*, 549 F.3d 736 (9th Cir. 2008).

⁸³ See 15 U.S.C. § 78dd-1.

⁸⁴ *Glazer Capital Management LP v. Magistri*, N. 82 *supra*, 549 F.3d at 739.

⁸⁵ *Id.*, 549 F.3d at 740.

Glazer filed a Second Amended Consolidated Complaint.⁸⁶ The district court dismissed the Second Amended Consolidated Complaint, concluding that Glazer had not adequately pled either falsity or scienter with respect to the alleged misstatements. The court also denied Glazer leave to file a third amended complaint.⁸⁷

Glazer appealed and the Ninth Circuit affirmed, concluding that the complaint failed to adequately plead scienter with respect to the three alleged misstatements. The court first considered whether a corporate officer must have requisite scienter or whether the plaintiffs “[could] rely on a theory of ‘collective scienter,’ which would hold the company as a whole responsible for the statements contained in the merger agreement.”⁸⁸ Glazer urged the court to follow the Second and Seventh Circuits in adopting a theory of “collective scienter” for purposes of PSLRA pleading. However, the court noted that the Fifth and Eleventh Circuits have rejected the “collective scienter” theory. In the end, the court decided it was unnecessary to choose sides and, instead, held that the “PSLRA require[d] Glazer to plead scienter with respect to those individuals who actually made the false statements in the merger agreement.”⁸⁹ In view of this requirement, the court found that the plaintiffs had pled no facts that directly demonstrated that the corporate officer possessed the requisite scienter when he made the representations contained in the merger agreement. Accordingly, the Ninth Circuit concluded that the district court did not err in dismissing the action.⁹⁰

[4]—The Sarbanes-Oxley Act of 2002

Passage of the Sarbanes-Oxley Act of 2002 (the “Act”)⁹¹ represents a change in direction from the previous expression of congressional support for self-policing in the corporate context. In response to a series of corporate scandals (most notably Enron Corporation, which previous to filing for bankruptcy had been the seventh largest publicly held company, and similar scandals surrounding Global Crossing Ltd., WorldCom Inc., and Adelphia Communications Corp.), Congress enacted the Sarbanes-Oxley Act to restore public confidence in the securities markets by addressing corporate governance, auditor independence, and auditor oversight issues.⁹² Because many of the

⁸⁶ *Id.*

⁸⁷ *Id.*

⁸⁸ *Id.*, 549 F.3d at 743.

⁸⁹ *Id.*, 549 F.3d at 745.

⁹⁰ *Id.*, 549 F.3d at 749.

⁹¹ Pub. L. No. 107-204, 116 Stat. 745 (July 30, 2002). See Appendix H *infra*, Selected Provisions from the Sarbanes-Oxley Act of 2002.

⁹² For a detailed examination of the entire Sarbanes-Oxley Act, see generally: Bloomenthal, *Sarbanes-Oxley Act in Perspective* (West 2002); Hamilton and Trautman,

provisions of the Act are to be implemented by SEC rulemaking, are subject to the interpretive authority of the SEC, and require case law to determine how they will be applied, the ultimate implications of the Act remain to be seen. It is, nevertheless, clear from the outset that the Act raises the bar for corporate accountability and will consequently have an effect on derivative litigation.

The Act's principal rules provide for:

- (1) the creation of an independent accounting oversight board⁹³;
- (2) rules designed to ensure auditor independence⁹⁴;
- (3) measures that address corporate governance and responsibility⁹⁵;
- (4) extended disclosure requirements⁹⁶;
- (5) requirements that analysts disclose potential conflicts of interest⁹⁷;
- (6) an extension of the statute of limitations for violations of federal securities laws⁹⁸; and
- (7) several extensions of criminal and civil penalties for fraud and other violations of the law.⁹⁹

The Act also requires that various studies be conducted and that funding for the SEC be substantially increased.¹⁰⁰

Several provisions of the Act have proven relevant to derivative suits. First, the extension of the statute of limitations for securities laws has provided complaining shareholders with additional time in which to bring suits. The Act increased the statute of limitations for civil suits alleging securities fraud from one year after discovery or three years after the questioned transaction to two years after discovery or within five years after the questioned transaction.¹⁰¹ Second, and perhaps with the most substantial effect on derivative litigation, is the Act's requirement that the SEC promulgate rules of professional conduct for lawyers.¹⁰² Under the Act, lawyers practicing or appearing before the SEC must report any potential material violation of the

Sarbanes-Oxley Act of 2002 (CCH 2002); McAlevey, ed., *Understanding the Sarbanes-Oxley Act of 2002: What Every Corporate and Securities Lawyer Needs to Know Now* (PLI 2002).

⁹³ Sarbanes-Oxley Act §§ 101-109, 15 U.S.C. §§ 7211-7219.

⁹⁴ Sarbanes-Oxley Act §§ 201-209, 15 U.S.C. §§ 78j-1, 7231-7234.

⁹⁵ Sarbanes-Oxley Act §§ 301-308, 15 U.S.C. §§ 77t, 78j-1, 78u, 7241-7246.

⁹⁶ Sarbanes-Oxley Act §§ 401-409, 15 U.S.C. §§ 78m, 78p, 7261-7266.

⁹⁷ Sarbanes-Oxley Act § 501, 15 U.S.C. §§ 78a, 78o-6.

⁹⁸ Sarbanes-Oxley Act § 804, 28 U.S.C. § 1658.

⁹⁹ Sarbanes-Oxley Act §§ 801, 805, 807, 901-906, Pub. L. No. 107-204, 116 Stat. 800-806 (codified as amended in scattered sections of 18 U.S.C. and 28 U.S.C.).

¹⁰⁰ Sarbanes-Oxley Act §§ 601-604, 701-705, 15 U.S.C. §§ 78, 7201.

¹⁰¹ Sarbanes-Oxley Act § 804, 28 U.S.C. § 1658.

¹⁰² Sarbanes-Oxley Act § 307, 15 U.S.C. § 7245.

securities laws or a breach of fiduciary duties, defined as violations that a reasonable investor would want to know about, to the corporation's chief legal counselor or chief financial officer. If the lawyer does not see that reasonable remedial measures, and where required, sanctions have been taken, the lawyer must inform the corporation's audit committee, an alternative committee of independent directors or the full board of directors. While the Sarbanes-Oxley Act provides that only the SEC can enforce these provisions and does not provide a right to private enforcement litigation, the requirements may provide another avenue for discovery for plaintiffs in derivative suits.

One example of such litigation can be found in *Beam v. Stewart*, which was brought, in part, on the plaintiff's claim that the directors of Martha Stewart Living Omnimedia did not address the impropriety of the company's payment of split-dollar insurance policy premiums to Ms. Stewart, the CEO.¹⁰³ Because the premiums for these policies are paid entirely or in large part by an employer, there was a suggestion that this type of insurance policy could constitute an interest-free loan to employees and might therefore violate the SOX provisions that ban loans to corporate executives and directors.¹⁰⁴ The court in *Beam*, however, dismissed this claim, on the grounds that: (1) the plaintiff did not plead facts showing that the payment of the premiums were *per se* unlawful; (2) the directors had previously disclosed the existence of the policy; and (3) the company was looking into whether the policy should be discontinued in light of the new SOX provisions.¹⁰⁵

Plaintiffs have also attempted to use this aspect of Sarbanes-Oxley as a means by which to file derivative claims in federal court, yet it is unclear whether such attempts will be successful. For example, in *Neer v. Pelino*, shareholders filed a derivative action in the Eastern District of Pennsylvania, alleging breaches of fiduciary duty, abuse of control, gross mismanagement, waste of corporate assets, unjust enrichment and violations of Section 304 of the Sarbanes-Oxley Act.¹⁰⁶ Defendants moved to dismiss for lack of subject matter jurisdiction on the grounds that Section 304 does not provide a private right of action for plaintiffs. The court agreed, basing its analysis on the difference between Section 304 and Section 306.¹⁰⁷ Although both of these provisions address wrongdoing of officers and provide for the issuers' reimbursement in response to such wrongdoing, only Section 306 includes an explicit private right of action; therefore, the court

¹⁰³ *Beam v. Stewart*, 833 A.2d 961, 975 (Del. Ch. 2003), *aff'd* 845 A.2d 1040 (Del. 2004).

¹⁰⁴ See Sarbanes-Oxley Act § 402(a), 15 U.S.C. § 78m(k).

¹⁰⁵ *Beam v. Stewart*, N. 103 *supra*, 833 A.2d at 975.

¹⁰⁶ *Neer v. Pelino*, 389 F. Supp.2d 648 (E.D. Pa. 2005).

¹⁰⁷ Section 304 of the Sarbanes-Oxley Act provides:

found that the “natural inference is that Congress did not intend to create a private right of action in Section 304.”¹⁰⁸

Finally, many of the provisions of the Act increase the role of independent directors and committees of independent directors in corporations. Among these provisions are those requiring changes in board composition and the function of independent directors, and committees made up of independent directors.¹⁰⁹ In particular, the Act’s requirement that corporations have audit committees composed only of independent directors, at least one of whom is a financial expert, is arguably one of the biggest fundamental changes in the laws regarding corporate governance in recent years. Taken as a whole, these changes are designed to protect shareholders by instituting greater checks and balances on senior corporate officers and senior management.

[5]—The Dodd-Frank Wall Street Reform and Consumer Protection Act

In July 2010, President Barack Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) into law.¹¹⁰ Enacted in response to the economic downturn of 2008-2009,¹¹¹ the Dodd-Frank Act delivered a sweeping amount of regulatory oversight to existing and newly created federal agencies and offices tasked with maintaining financial stability and improving transparency and accountability in the corporate and financial sectors. The Dodd-Frank Act is geared toward improvement of existing securities

“If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for (1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and (2) any profits realized from the sale of securities of the issuer during that 12-month period.”

15 U.S.C. § 7243.

¹⁰⁸ *Neer v. Pelino*, N. 106 *supra*, 389 F. Supp.2d at 655.

See also:

Second Circuit: In re Bisys Group Inc. Derivative Action, 396 F. Supp.2d 463, 464 (S.D.N.Y. 2005) (finding that because there is “nothing in the legislative history to suggest an intention to create a private right of action . . . [Section 304] does not expressly create a private cause of action in favor of the issuer or, for that matter, anyone else”).

Ninth Circuit: *Kogan v. Robinson*, 432 F. Supp.2d 1075, 1082 (S.D. Cal. 2006).

¹⁰⁹ Sarbanes-Oxley Act §§ 201-206, 301, 15 U.S.C. §§ 78c(a), 78j-1.

¹¹⁰ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

¹¹¹ *Id.* at Preamble.

and banking laws,¹¹² consumer protection,¹¹³ mortgage and lending reform,¹¹⁴ expansion of SEC enforcement power¹¹⁵ and the restriction of future government bailouts.¹¹⁶

Certain provisions of the Dodd-Frank Act may impact shareholder derivative litigation by affecting director liability, executive compensation and shareholder power over corporate governance.

- Section 922 creates a “Whistleblower Incentive” program. Under the program, persons who voluntarily provide information leading to a successful SEC enforcement action in which sanctions of \$1 million or more are recovered will receive a bounty of 10% to 30% of the sanctions. Tips may be given anonymously.¹¹⁷
- Section 929L extends the prohibitions on market manipulation found in Sections 9 and 10(a) of the Securities Exchange Act of 1934 (Exchange Act) to all non-government securities, including over-the-counter (OTC) securities.¹¹⁸ Prior to the passage of the Dodd-Frank Act, Sections 9 and 10(a) of the Exchange Act applied only to securities listed on a national securities exchange.
- Section 929P grants the SEC power to bring enforcement actions against “controlling persons”—that is, persons found to have had direct or indirect control over a person who violated the securities laws. Previously, Section 20(a) of the Exchange Act could be interpreted so as to restrict suits against controlling persons to private litigants.¹¹⁹
- Section 929P further grants the SEC power to seek monetary penalties in administrative “cease and desist” hearings.¹²⁰
- Section 951, the “Say on Pay” provision, requires public companies to include in proxy materials a resolution, subject to non-binding shareholder vote, approving executive compensation.

¹¹² See *id.* at Titles I, IV, VI, VII and IX.

¹¹³ See *id.* at Title X.

¹¹⁴ See *id.* at Title XIV.

¹¹⁵ See *id.* at Titles VII and IX.

¹¹⁶ See *id.* at Titles II and XIII.

¹¹⁷ *Id.* at § 922 (to be codified at 15 U.S.C. § 78u-6) (adding Section 21F to the Securities Exchange Act of 1934).

¹¹⁸ *Id.* at § 929L (to be codified at 15 U.S.C. § 78i) (amending Section 9 of the Securities Exchange Act of 1934).

¹¹⁹ *Id.* at § 929P(c) (to be codified at 15 U.S.C. § 78t). See also, 15 U.S.C. § 77t(a).

¹²⁰ Dodd-Frank Wall Street Reform and Consumer Protection Act, N. 110 *supra*, at § 929P(c) (to be codified at 15 U.S.C. § 78t). See also, 15 U.S.C. § 77h-1.

Shareholders must vote on executive compensation at least once every three years.¹²¹

- Section 951 also includes a “Golden Parachute” provision requiring companies to include in any proxy or consent solicitation materials seeking shareholder approval of an acquisition, merger, consolidation or disposition of all or substantially all of the company’s assets a resolution, subject to non-binding shareholder vote, approving certain payments to executive officers in connection with the transaction.¹²²
- Section 952 directs the SEC to promulgate rules requiring publicly traded companies to establish an Independent Compensation Committee.¹²³
- Section 953 directs the SEC to promulgate rules requiring greater and more specific disclosures regarding executive compensation.¹²⁴
- Section 954 requires public companies to develop and implement “clawback” provisions that allow recovery of incentive-based compensation (including stock options) from current and former executives for the prior three years in the event of a financial restatement due to material noncompliance with any financial reporting requirement under the securities laws. Companies may recover the difference between actual compensation and the appropriate compensation under the restated financials.¹²⁵
- Section 971 allows the SEC to issue rules permitting shareholders to use a company’s proxy solicitation materials to nominate members of the board of directors.¹²⁶

The aforementioned provisions may add fuel to allegations of failed or negligent corporate governance. Whistleblower provisions may provide a financial incentive for employees who are also shareholders to (1) gather reportable information that could form the basis of shareholder derivative claims, and (2) sidestep a corporation’s internal procedures for reporting securities violations and, instead, report a matter directly to the SEC. Indeed, there are already starting to be some

¹²¹ Dodd-Frank Wall Street Reform and Consumer Protection Act, N. 110 *supra*, at § 951 (to be codified at 15 U.S.C. § 78n-1). See also, 15 U.S.C. § 78n.

¹²² Dodd-Frank Wall Street Reform and Consumer Protection Act, N. 110 *supra*, at § 951 (to be codified at 15 U.S.C. § 78n-1).

¹²³ *Id.* at § 952 (to be codified at 15 U.S.C. § 78j-3) (adding Section 10C to the Securities Exchange Act of 1934).

¹²⁴ *Id.* at § 953(a)-(b), 15 U.S.C. § 78n.

¹²⁵ *Id.* at § 954 (to be codified at 15 U.S.C. § 78j-4) (adding Section 10D to the Securities Exchange Act of 1934).

¹²⁶ *Id.* at § 971, 15 U.S.C. § 78n(a).

visible changes in the shareholder derivative landscape due to Dodd-Frank. For example, in the first two years since the law was passed, nearly eighty companies failed to receive majority support in votes pursuant to Dodd-Frank's "Say on Pay" provision, resulting in shareholder derivative challenges that were filed soon after.¹²⁷

¹²⁷ Poerio et al., *Staying in Front of the Shareholder Litigation Challenges to Executive Compensation*, June 14, 2012, available at <http://www.paulhastings.com/publicationdetail.aspx?publicationId=2203>.

§ 1.05 Nature of the Derivative Suit

Why has the derivative action endured in the face of both legislative and judicial challenges to it? One possibility is that this form of litigation is a vehicle for strike suits by aggressive and entrepreneurial lawyers for plaintiffs, offering these lawyers handsome rewards for bringing and settling these cases. Indeed, when one practices in this area, one discovers that this is the uninitiated view held by most corporate executives and members of a board of directors. Corporate management and board members often view all shareholder derivative litigation as attempts by a shareholder or his lawyer to “hold up” the corporation for a quick and lucrative settlement.

It is important to realize, of course, that where there is smoke, there is often fire, and some of the mistrust of shareholder derivative actions is based on a measure of truth. Those throwing pointed sticks at this type of litigation can point to statistical evidence showing the extremely low rate of victories by plaintiffs in litigated cases. In a study conducted in the 1940s by the New York Chamber of Commerce, it was found that of 573 derivative actions filed against public companies between 1932 and 1942, only thirteen resulted in judgment for the plaintiffs.¹ A more recent study has shown that plaintiffs in class and derivative suits were victorious in less than 1% of all litigated cases, with the vast majority of the cases examined being resolved through settlement.²

The reader should also remember Mr. Venner³ and his long and infamous history of initiating litigation for the purpose of obtaining settlements. There are individuals in the modern era who, it can be argued, exhibit some of the characteristics of “Sue and Settle” Venner. It has been suggested that one such individual is Mr. Harry Lewis, who “by his own account in sworn depositions has served as named plaintiff in ‘several hundred’ filed cases and at least fifty-two reported corporate and securities law decisions in federal courts.”⁴ Why do these plaintiffs prosecute derivative actions? There has been speculation

¹ Wood, *Survey and Report Regarding Stockholder Derivative Suits* 32 (1944), cited in Coffee, “Understanding the Plaintiff’s Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions,” 86 Colum. L. Rev. 669, 698 and n.81 (1986). This study resulted in the passage by New York State of the security-for-expense statute discussed in § 1.03 *supra*.

² Coffee, “Understanding the Plaintiff’s Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions,” 86 Colum. L. Rev. 669, 698 and n.83 (1986), citing Jones, “An Empirical Examination of the Resolution of Shareholder Derivative and Class Action Lawsuits,” 60 B.U.L. Rev. 542, 544-545 (1980).

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⁴ Coffee, “Understanding the Plaintiff’s Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions,” 86 Colum. L. Rev. 669, 682 and n.38 (1986).

that such plaintiffs have secret fee-splitting arrangements with their attorneys.⁵ There is also speculation that such plaintiffs simply enjoy bringing the suits.⁶ One further possibility is that modern plaintiffs are now sometimes offered “incentive fees” for prosecuting derivative actions. These incentive fees typically amount to \$10,000 or \$20,000 and provide shareholders with a return for filing and prosecuting a lawsuit especially, as is generally the case, when these shareholders have only a modest financial stake in the enterprise.

The view that shareholder derivative litigation is sometimes a vehicle for strike suits is also rooted in the behavior of plaintiffs’ lawyers.⁷ Shareholder derivative actions are generally controlled by plaintiffs’ attorneys.⁸ In most instances, usually on the heels of a highly visible adverse event, it is the plaintiff’s counsel who identifies a case in which a derivative suit may be appropriate or successful, and who locates a shareholder willing to lend his name to the litigation.⁹ In such a case, unlike most types of litigation, some say that the real plaintiff in interest is not the shareholder but the plaintiff’s lawyer.

“[T]he shareholder plaintiffs are quite often little more than a formality for purposes of the caption rather than parties with a real interest in the outcome. Since any judgment runs to the corporation, shareholder plaintiffs at best realize an appreciation in the value of their shares. The real incentive to bring derivative actions is usually not the hope of return to the corporation but the hope of handsome fees to be recovered by plaintiffs’ counsel.”¹⁰

The fact that it is often the plaintiff’s attorney rather than the shareholder who is, for practical purposes, the real party in interest may even create a conflict of sorts between the interests of the shareholder, which are normally to protect or increase the value of his investment in the corporation, and the shareholder’s counsel, which are normally to increase the amount of damages, and hence the amount of attorneys’ fees, awarded in the case.

“[T]here is a danger in authorizing lawyers to bring actions on behalf of unconsulted groups. Derivative suits may be brought for

⁵ Id.

⁶ Id.

⁷ For a detailed discussion of the roles of attorneys in class and derivative litigation, see Macey and Miller, “The Plaintiffs’ Attorney’s Role in Class and Derivative Litigation: Economic Analysis and Recommendations for Reform,” 58 U. Chi. L. Rev. 1 (1991).

⁸ See Coffee, N. 4 *supra*, 86 Colum. L. Rev. at 677-681.

⁹ Id.

¹⁰ Joy v. North, 692 F.2d 880, 887 (2d Cir. 1982), *cert. denied* 460 U.S. 1051 (1983). See also, Cary and Eisenberg, *Corporations* 938 (5th ed. 1980).

their nuisance value, the threat of protracted discovery and litigation forcing settlement and payment of fees even where the underlying suit has modest merit. Such suits may be harmful to shareholders because the costs offset the recovery. Thus, a continuing debate surrounding derivative actions has been over restricting their use to situations where the corporation has a reasonable chance for benefit.”¹¹

It is at least sometimes true that a plaintiff’s lawyer initiates a derivative suit against an “innocent” board in order to force a quick settlement and, therefore, receive a quick fee. As Mr. Justice Jackson noted in 1949:

“Unfortunately, the remedy [for derivative suits] itself provided opportunity for abuse which was not neglected. Suits sometimes were brought not to redress real wrongs, but to realize upon their nuisance value. They were bought off by secret settlements in which any wrongs to the general body of share owners were compounded by the suing stockholder, who was mollified by payments from corporate assets. These litigations were aptly characterized in professional slang as ‘strike suits.’”¹²

The conflict between a derivative plaintiff and counsel, to the extent that it exists, may also manifest itself during settlement negotiations. This is because named plaintiffs, by suing in a representative capacity, give up the right to unilaterally dictate the outcome of an action unilaterally. As a result:

“[C]ounsel in a derivative and/or class action may present a proposed settlement over the objections of the named plaintiffs. The mere fact that the counsel takes a different view on the advisability of a settlement than the named clients does not, in itself, constitute grounds for disqualification.”¹³

The derivative suit is not, however, without its proponents. As one leading text suggests, “the derivative suit is an extremely important remedial and deterrent device to police and prevent management abuses and to protect minority shareholders and others concerned with the welfare of the corporation.”¹⁴ Even the Supreme Court has recognized

¹¹ Joy v. North, N. 10 *supra*, 692 F.2d at 887.

¹² Cohen v. Beneficial Industrial Loan Corp., 337 U.S. 541, 548, 69 S.Ct. 1221, 93 L.Ed. 1528 (1949).

¹³ In re M&F Worldwide Corp. Shareholders Litigation, 799 A.2d 1164, 1175 (Del. Ch. 2002).

¹⁴ Frey, Chopper, Leech and Mooris, *Cases and Materials on Corporations* 654 (1977). See also, Hornstein, “The Shareholder Derivative Suit in the United States,” J. Bus. L. 282, 288 n.27 (1967), quoting Minutes of Evidence Taken Before the

the inherent value in the derivative action: “[D]erivative suits have played a rather important role in protecting shareholders of corporations from the designing schemes and wiles of insiders who are willing to betray their company’s interests in order to enrich themselves.”¹⁵

Some courts have even recognized the valuable role of derivative actions while also noting their flaws.

“Despite the numerous abuses which have developed in connection with such suits they have accomplished much in policing the corporate system especially in protecting corporate ownership as against corporate management. They have educated corporate directors in the principles of fiduciary responsibility and undivided loyalty. They have encouraged faith in the wisdom of full disclosure to stockholders. They have discouraged membership on boards by persons not truly interested in the corporation. . . . The measure of effectiveness of the stockholder’s derivative suit cannot be taken by a computation of the money recovery in the litigated cases. The minatory effect of such actions has undoubtedly prevented diversion of large amounts from stockholders to management and outsiders.”¹⁶

Moreover, some commentators have suggested that “strike suit litigation is relatively uncommon.”¹⁷ Using economic theory, Professors Macey and Miller argue that strike suit litigation appears likely to occur infrequently because defendants in such cases are unlikely to settle for fear of being subject to additional suits, while plaintiffs are unlikely to prosecute such actions because their relatively low probability of success cannot justify the substantial risk of resources associated with prosecuting such an action.¹⁸

Professor Coffee has suggested that even the low rate of success should not be used as a measure of judging the overall merit of derivative litigation. He notes that the “low incidence of litigated plaintiff’s victories in class and derivative actions seems to be less evidence of extortion by plaintiffs than it is corroboration” of the fact that defendants

(Jenkins) Company Law Committee 1012 and 1069 (Feb. 10, 1961) (“Generally speaking, the right of stockholders to bring actions in such [derivative] cases has a good effect in our corporate law. . . .” “[I]t is true that stockholders’ suits and the always present threat of stockholders’ suits, constitute one of the strong checks on improper corporate action.”).

¹⁵ *Suowitz v. Hilton Hotels Corp.*, 383 U.S. 363, 371, 86 S.Ct. 845, 15 L.Ed.2d 807 (1966).

¹⁶ *Brendle v. Smith*, 46 F. Supp. 522, 525-526 (S.D.N.Y. 1942).

¹⁷ Macey and Miller, “The Plaintiffs’ Attorney’s Role in Class and Derivative Litigation: Economic Analysis and Recommendations for Reform,” 58 U. Chi. L. Rev. 1, 78 (1991).

¹⁸ *Id.*

only tend to litigate cases in which they have a strong chance of succeeding and settle those in which they appear likely to lose.¹⁹

It can also be argued that a plaintiff's lawyer, even if somewhat mercenary, is no different than any other private attorney general sanctioned under law. Such persons have traditionally been awarded attorneys' fees and expenses when their conduct has created a common benefit for a group of individuals. The theory is that society should encourage such persons to invest time and effort in prosecuting actions for the common good. It can be argued that the role of the plaintiff's attorney is similar to that of a private attorney general in that the plaintiff's attorney creates a benefit that inures to the benefit of all the shareholders of the corporation.

This view was cogently set forth by Chancellor Chandler:

"The allegation that attorneys bring [derivative] actions through puppet plaintiffs while the real parties in interest are the attorneys themselves in search of fees is an oft-heard complaint from defendants in derivative suits. Sometimes, no doubt, the allegation rings true.

"By the same token, however, the mere fact that lawyers pursue their own economic interest in bringing derivative litigation cannot be held as grounds to disqualify a derivative plaintiff. To do so is to impeach a cornerstone of sound corporate governance. Our legal system has privatized in part the enforcement mechanism for policing fiduciaries by allowing private attorneys to bring suits on behalf of nominal shareholder plaintiffs. In so doing, corporations are safeguarded from fiduciary breaches and shareholders thereby benefit. Through the use of cost and fee shifting mechanisms, private attorneys are economically incentivized to perform this service on behalf of shareholders. . . . To be sure, a real possibility exists that the economic motives of attorneys may influence the remedy sought or the conduct of the litigation. This influence, however, is inherent in private enforcement mechanisms and does not necessarily vitiate the substantial beneficial impact upon the conduct of fiduciaries."²⁰

The extent to which shareholders or shareholders' lawyers abuse the derivative form of action is not known, and is perhaps unknowable. It is fair to assume that some derivative actions are in fact filed and prosecuted based on an improper motive, while others are filed and prosecuted by well-intentioned individuals who fully believe that they are validly championing the rights of shareholders in the face of unfaithful management.

¹⁹ Coffee, "Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions," 86 Colum. L. Rev. 669, 700-701 (1986).

²⁰ *In re Fuqua Industries, Inc.*, 752 A.2d 126, 132-133 (Del. Ch. 1999).

Whatever the motive of the shareholder filing the action, it must be remembered that the shareholder derivative action is a valid legal device with the express sanction of legislation and common law. Thus, a corporation in receipt of a derivative demand or faced with a derivative action should not greet it with hostility. Instead, the corporation should look upon the derivative proceedings as an opportunity to engage in a form of self-analysis. Corporations should take the shareholders' complaint seriously and undertake an appropriate investigation to determine whether the shareholders' claim—that is, the claim of the true owners of the corporation—has merit and what action should be taken in response to the demand. The nature and scope of the appropriate investigation will naturally vary with the depth, breadth, and seriousness of the allegations.

As will be explored in subsequent chapters, the law surrounding derivative actions has gone to some length to balance the competing interests of directors and shareholders. As part of the balancing act, the law imposes a number of prerequisites on shareholders before they can bring an action derivatively on behalf of the corporation, the most significant being the demand requirement. For example, before initiating a derivative action, a shareholder must generally bring the matter to the attention of the board of directors and request that the board take the action requested by the shareholder. If the board refuses, the shareholder may bring the requested action derivatively on behalf of the corporation only after he establishes that the board's refusal to do so is the result of a breach of the board's fiduciary duties to the corporation.

The result of the balancing act is a highly complex and burdensome set of procedures that, while designed to ensure fairness, are also time-consuming, expensive, and in some cases, even subject to abuse themselves. The consequence of this result is often that both parties are forced into a hostile posture at the outset of a derivative suit, limiting whatever opportunities might exist for a productive dialogue about what both parties normally claim to be protecting, namely, the best interests of the corporation.

It is part of our hope in writing this book that a better understanding of both the law and the practice of shareholder derivative litigation will produce a greater willingness on the part of all parties involved to seek, when possible, productive and beneficial resolution to such disputes. To do this, both sides, shareholders and management, will have to lower their guard and engage in open discussions. This involves shareholders having a measure of trust in the integrity of the board to examine challenged conduct. It also involves the board taking a hard and dispassionate look at the challenged conduct without viewing it through the distorting prism that results from the belief that shareholders are improperly motivated.

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Moreover, some commentators have suggested that “strike suit litigation is relatively uncommon.”¹⁷ Using economic theory, Professors Macey and Miller argue that strike suit litigation appears likely to occur infrequently because defendants in such cases are unlikely to settle for fear of being subject to additional suits, while plaintiffs are unlikely to prosecute such actions because their relatively low probability of success cannot justify the substantial risk of resources associated with prosecuting such an action.¹⁸

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As will be explored in subsequent chapters, the law surrounding derivative actions has gone to some length to balance the competing interests of directors and shareholders. As part of the balancing act, the law imposes a number of prerequisites on shareholders before they can bring an action derivatively on behalf of the corporation, the most significant being the demand requirement. For example, before initiating a derivative action, a shareholder must generally bring the matter to the attention of the board of directors and request that the board take the action requested by the shareholder. If the board refuses, the shareholder may bring the requested action derivatively on behalf of the corporation only after he establishes that the board's refusal to do so is the result of a breach of the board's fiduciary duties to the corporation.

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