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Warding Off Shareholder Derivative Suits: Diligence and Faithfulness Are the Keys

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Corporate directors know that they may be named individually in lawsuits when shareholders disagree with board decisions or are disappointed in company results. For example, Goldman Sachs' directors continue to defend themselves against shareholder lawsuits filed this spring arising out of the Abacus deal, which related to the marketing of synthetic collateralized debt obligations known as CDOs.

This is despite the fact that, in July 2010, Goldman settled the Abacus-related claims brought by the Securities and Exchange Commission for $550 million.

The Goldman-Abacus situation is a representative example of a scenario in which shareholders — seeking to act on behalf of the company via a vehicle known as a ***derivative lawsuit*** — challenge the board of directors' substantive business decisions and the disclosures the company made, or failed to make.

In derivative cases, shareholders request damages for the company, governance reform, injunctive relieve, and legal fees for plaintiff's counsel. Insurance policies or the company often pay to defend and indemnify director-defendants in derivative suits, absent a finding that the director engaged in intentional misconduct.

What can companies and directors do to prevent these suits? What preliminary defenses can directors assert against a derivative suit?

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While there is no silver bullet to ward off litigation, directors can minimize their liability, and even their chances of having to defend against derivative suits beyond the motion-to-dismiss stage, by following basic good-governance procedures and taking common sense precautions.

A "cardinal precept" of Delaware corporate law, which governs or guides the affairs of many publicly and privately held companies nationwide, is that "directors, rather than shareholders, manage the business affairs of the corporation." *Aronson v. Lewis* (1984).

Accordingly, a shareholder who wishes to stand in the shoes of the corporation, and bring a suit against the directors on behalf of the corporation, must meet legal standards demonstrating the right to take over what otherwise would be the board's job. In most circumstances, derivative plaintiffs allege that any pre-suit demand for the board to prosecute the claims on its own would have been "futile."

In order to bring a derivative suit, therefore, a plaintiff must show either that (a) the directors were not "disinterested" or "independent" with regard to the challenged transaction or (b) the challenged transaction was not the product of a valid exercise of business judgment.

An "interested" director is one whose personal interests conflict with the company's interests. A decision of the board loses the protection of the "business judgment rule" where a plaintiff makes a particularized showing that the decision-makers failed to follow adequate decision-making procedures or that the decision failed to serve any rational business purpose.

Many companies exculpate their directors for violations of the duty of care, and therefore, most derivative suits will succeed only where a plaintiff can demonstrate that the directors acted in bad faith, such as where the directors intentionally acted with a purpose other than advancing the best interests of the corporation or in conscious disregard of their own duties.

In light of this legal framework, corporate directors should take comfort that they can protect themselves from liability — and often defeat a derivative suit, when one is brought, on a motion to dismiss — if boards follow preset corporate procedures, articulate business rationales for their decisions, and avoid even the appearance of self-interestedness or self-dealing.

Allegations in derivative suits tend to fall within familiar categories, including failure to disclose relevant information, waste of corporate assets by overcompensating executives, waste of corporate assets by entering into unfavorable transactions, and general failure to exercise adequate oversight of company affairs.

Failure to disclose material information: *A recent example of this category of claim is Goldman's failure to disclose that it had received a Wells notice from the SEC in the summer of 2009, which indicated the SEC was likely to sue Goldman for the Abacus deal, when such information would have been of interest to investors.*

Coincidentally, after receiving the Wells notice, but before disclosing the SEC's investigation, certain Goldman directors and insiders sold company shares. Shareholders seeking to prosecute derivative claims have alleged in suits filed in April 2010 that failure to disclose, coupled with purported insider trading, constituted a breach of the directors' fiduciary duties.

Waste via rich compensation packages: *Another common allegation is that the board made improper or ill-advised gifts to departing executives, thereby wasting corporate assets. In a derivative suit against Citigroup's directors following the 2008 financial crisis, the only allegation to survive the 2009 motion to dismiss was that the board had committed waste with regard to a compensation package granted to the departing CEO.*

When considering a charge of waste, the court considers whether there was "an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade." In re Citigroup Inc. S'holder Deriv. Litig. (2009).

Waste via approval of an ill-advised transaction: A *third example of an often-seen derivative claim is where the board recommends a merger or acquisition of which the plaintiffs disapprove. Shareholders objected to Dow Chemical's merger agreement with Rohm & Haas, which unconditionally obligated Dow to consummate the merger.*

Those claims were dismissed where plaintiffs took issue not with the process the board followed, but with the board's substantive decisions, and "substantive second-guessing of the merits of a business decision … is precisely the kind of inquiry that the business judgment rule prohibits." In re Dow Chemical Co. Deriv. Litig. (2010).

Failure of oversight: *Shareholders also bring derivative claims based upon board inaction. In such cases, shareholders often contend that the board's failure of oversight permitted company managers to make bad decisions.*

For example, AIG shareholders alleged that the directors failed to respond to "red flags" that the company's credit default swap portfolio posed a risk to the company. In dismissing this and other claims in March 2010, the court reiterated that "Director liability based on the duty of oversight is possibly the most difficult theory in corporate law upon which a plaintiff may hope to win a judgment." In re American Int'l Group, Inc. Deriv. Litig. (2010).

In order to sustain such a claim, shareholders must plead, but did not in the AIG case, particularized facts showing that directors "knew they were not discharging their fiduciary obligations" or failed "to act in the face of a known duty to act."

In all such cases, the best defense to derivative claims will be a board's willingness to conduct due diligence, a board's ability to articulate a good faith and rational basis for its actions, and a board member's consideration of any appearance of a conflict of interest he or she may have before participating in the decision-making process or trading in the company's shares.

Boards may appoint special subcommittees in order to address issues that create an appearance of conflict if addressed by the board as a whole. When directors follow the golden rules of diligence and faithfulness, they increase the likelihood that they will avoid meritorious shareholder derivative claims and be able to present strong legal defenses to claims that amount to little more than Monday morning quarterbacking — something Delaware's business judgment rule is designed to prevent.

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