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Directors' and Officers' Liability:

Shareholder Derivative Litigation Developments

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Federal and Delaware state courts have recently issued noteworthy decisions addressing important aspects of shareholder derivative litigation. This column examines (i) two decisions underscoring that the pre-suit demand requirement is no idle ritual for the putative plaintiff; (ii) definitive guidance from the Delaware Supreme Court on the requirements for maintenance of a "double derivative" suit; and (iii) last month's Delaware Court of Chancery ruling that unlike in the corporate context—where creditors of an insolvent corporation may maintain derivative claims on behalf of the corporation—creditors of an insolvent Delaware limited liability company (LLC) lack standing to maintain derivative claims. The latter decision illustrates important differences between Delaware corporations and LLCs, including that because LLCs are creatures of contract authorized by an LLC Act designed to afford parties maximum freedom of contract, LLC agreements do not automatically incorporate all of the general common law and equitable aspects of corporation law.

Shareholder Status

Only an actual shareholder can make a demand that the board investigate alleged wrongdoing and institute litigation for the corporation. Fed. R. Civ. P. 23.1 and scores of state analogs thus require a putative shareholder derivative plaintiff to plead with particularity that "the plaintiff was a shareholder…at the time of the transaction of which the plaintiff complains." The prevailing view interprets this provision to require that the derivative plaintiff be a beneficial owner of stock at the

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time of the alleged wrongful acts and retain ownership of the stock for the duration of the lawsuit. The purpose of the "contemporaneous ownership" requirement is to prevent the purchasing of shares in order to maintain a derivative action designed to challenge a transaction that occurred before the purchase of stock.

The "continuous ownership" requirement, a judicially created rule, is animated by concern that to "permit a party to act as a derivative plaintiff when it has emptied itself of any economic interest in the corporation would invite abuse of the representative litigation mechanism, undermining its credibility and its utility in enforcing high standards of fiduciary conduct."[1] Courts generally will not permit a plaintiff to bring a shareholder derivative claim without specific allegations regarding when they purchased the stock and how long they held it. A plaintiff who is not a stockholder at the time of the alleged wrong, or who ceases to be a stockholder while the suit is pending, lacks standing to maintain the derivative suit.

In *Richelson v. Yost*,[2] a putative derivative plaintiff sent a demand letter to the Board of AmerisourceBergen which did not state when he had purchased his shares, or contend that he held shares at the time of the events complained of; instead the letter stated only that plaintiff is "a holder of shares of common stock of" the company. Ten days later the company responded to the purported demand by stating that after reviewing its books and records, the company had no record of plaintiff's status as a shareholder and requested that he provide evidence of his share ownership before the board would consider his demand. Plaintiff provided no additional information, and instead filed a putative shareholder derivative complaint in Pennsylvania federal court seeking to allege the claims described generally in the demand. In the complaint, plaintiff alleged that he was a shareholder "at the time of the wrongdoing" and "continuously since that time," and therefore could sue derivatively because the board did not respond to his demand. Defendants moved to dismiss for lack of standing, and the court granted the motion.

Having made a demand, the court noted, plaintiff as a matter of law conceded the independence and disinterestedness of a majority of the board to respond, subjecting the board's response to business judgment review. Finding little authority addressing whether a board must act on a demand from an alleged shareholder whose status as a shareholder cannot be confirmed by the company, the court determined that "the mechanics of the derivative suit and applicable precedent confirm that Defendants had no such obligation."

Although the contemporaneous ownership and continuous ownership requirements "do not explicitly impose an obligation on the shareholder making demand to affirmatively prove that he or she is a shareholder in the demand letter," the court determined "these requirements do demonstrate that the board of directors need not act upon a purported shareholder's demand letter if, after reasonable investigation undertaken in good faith, the shareholder's status as a shareholder cannot be confirmed." The board's obligation after it receives a "demand" that fails to demonstrate shareholder status is to exercise due diligence to determine whether the demand letter came from a shareholder. The court stated that if the board cannot determine shareholder status, it may "discard Plaintiff's letter entirely" or request additional information which would verify shareholder status before proceeding on a demand.

Opportunity to Respond

Derivative plaintiffs frequently argue that the board's failure to provide them with a definitive response to a demand letter within a reasonable time evidences that further demand would be futile. Once a demand is made (and absent a wrongful refusal) a shareholder lacks the power to take any action concerning the proposed claim until the board has acted. Positing that no fixed period of time exists by which to measure whether suit was filed prematurely, courts have adopted a flexible rule that determines whether the board was given a reasonable opportunity under the circumstances to respond to the demand. A recent Massachusetts federal court decision illustrates that once the shareholder makes a demand on the board to sue, if the shareholder brings suit before the board responds to the demand, it does so at significant risk of dismissal for premature filing.

In *In re Smith & Wesson Holding Corp. Deriv. Litig.*,[3] the court dismissed a putative shareholder derivative complaint upon concluding that the board and the special litigation committee (SLC) thereof appointed to evaluate plaintiffs' demand acted reasonably in response to plaintiffs' demands and that plaintiffs' filing of a complaint four months after the initial demand letter and before the SLC completed its investigation deprived the board of its right to control the litigation.

Plaintiffs sent the board a demand to sue 10 directors and officers of the company, alleging only that from June 2007 to December 2007 the company, "with the knowledge, approval and/or acquiescence of the Directors and Officers, knowingly made false statements regarding the company's earnings and business prospects for fiscal year 2008 and the first two quarters thereof." The board, through counsel, responded to the demand by indicating that the SLC of the board composed of disinterested and independent members of the board had been appointed and was delegated the authority to evaluate and make all determinations concerning stockholder demands. The letter also requested additional information from plaintiffs regarding their adequacy to serve as derivative plaintiffs, to which plaintiffs did not respond.

A month later the SLC requested plaintiffs provide additional information concerning the nature and scope of the stockholder demands because the demand letters did not provide sufficient information for the SLC to make a meaningful evaluation. Plaintiffs refused to provide any additional information. The SLC responded by reiterating its need for additional information, but announced that it would proceed with the investigation and assume that the shareholders making demand were proceeding on the same facts underlying a related federal securities suit. Plaintiffs sued the next day.

The court ruled that plaintiffs' suit jumped the gun. That four and a half months elapsed between plaintiffs' first demand letter and the filing of the complaint, the court determined, held "little import in itself." Rather, the question was whether four and a half months was sufficient for the SLC to fully investigate the issues raised in plaintiffs' demand. It was not, because "the breadth and vagueness of the demands created serious difficulties for the SLC from the outset," and "the extent and complexity of the alleged misconduct warranted a probing and scrupulous investigation."

In addition, plaintiffs' refusal to elaborate on their broadly phrased demands delayed the investigation, frustrating the SLC's multiple attempts to gather information from plaintiffs so that it could focus its investigation. Accordingly, the court concluded that "plaintiffs have improperly treated the demand requirement as a mere formality," failing to provide the SLC with a sufficient opportunity to investigate the demand before filing suit, warranting dismissal of the complaint without prejudice.

Double Derivative Actions

A "double derivative" action is a derivative action maintained by a shareholder of a parent corporation to recover for a claim belonging to a wholly owned or majority-controlled subsidiary company. Although the shareholder of the parent corporation has no direct financial interest in the subsidiary (and thus lacks standing) the shareholder does have an interest in harm suffered indirectly by the parent corporation arising from injury to the subsidiary. The parent and subsidiary are both indispensable parties to the double derivative suit.

A common use of the double derivative action is where a shareholder plaintiff brings suit derivatively on behalf of a corporation that is subsequently acquired by another corporation in a stock-for-stock merger, and the plaintiff receives stock in the acquiring corporation in exchange for his shares in the acquired corporation. It has long been settled that in a post-merger double derivative action, the shareholder plaintiff must meet the demand or demand futility requirements as to the boards of both the acquired and the acquiring companies.

In *Lambrecht v. O'Neal*,[4] the Delaware Supreme Court answered a certified question of law submitted by a New York federal district court arising from two related actions in which claims were asserted on a "double derivative" basis on behalf of Bank of America (BofA) and its wholly owned subsidiary, Merrill Lynch & Co. Inc. In an en banc opinion, the Delaware Supreme Court considered the standing requirements for bringing a double derivative suit under Delaware law. Specifically, the Court addressed whether a plaintiff in a double derivative action who was a pre-merger shareholder of the acquired company and who is a current shareholder of the post-merger parent company only by virtue of a stock-for-stock merger, must also demonstrate that (a) he was a shareholder of the acquiring company at the time of the alleged wrongdoing at the acquired company, and (b) the acquiring company was a shareholder of the acquired company at the time of the alleged wrongdoing at the acquired company. The Delaware Supreme Court answered the questions in the negative, overruling the oft-cited Court of Chancery decision in *Saito v. McCall*[5] to the extent it is inconsistent with *Lambrecht*.

Lambrecht began as standard derivative actions on behalf of Merrill Lynch alleging purported breaches of fiduciary duties by Merrill Lynch directors and officers before BofA acquired Merrill Lynch in a stock-for-stock merger. After the merger was completed, the district court dismissed the suits without prejudice for lack of standing, in accordance with the continuous ownership requirement, i.e., by virtue of the merger the plaintiff was no longer a shareholder of Merrill Lynch.

Plaintiffs re-filed their claims as double derivative actions, seeking to require BofA to pursue a claim of Merrill Lynch, and defendants moved to dismiss, arguing that to have standing to sue double derivatively, the plaintiffs must be able to show: (a) that they were (and remain) shareholders of BofA both after the merger and also at the time of the pre-merger Merrill Lynch wrongdoing complained of, and (b) that BofA also was a shareholder of Merrill Lynch at the time of that pre-merger conduct.

The Delaware Supreme Court stated that the additional requirements proposed by defendants "would render double derivative lawsuits virtually impossible to bring," undermining Delaware law validating such actions "in cases where standing to maintain a standard derivative action is extinguished as a result of an intervening merger." Moreover, a requirement that BofA must have owned Merrill Lynch stock at the time of the pre-merger wrongdoing, the court emphasized, "incorrectly presupposes that to be legally capable of enforcing Merrill Lynch's pre-merger claim, BofA must proceed derivatively against the persons who were Merrill Lynch directors at the time of the alleged wrongdoing."

Rather, as a result of the merger, Merrill Lynch's claim became BofA property, and as the sole owner of Merrill Lynch, BofA was "not required to proceed derivatively; it may enforce that claim by the direct exercise of its 100 percent control." That is, BofA's sole ownership of its subsidiary empowered it to cause Merrill Lynch "to do what is necessary to enforce Merrill Lynch's pre-merger claim, which required only the shares BofA acquired through the merger." Similarly, the court concluded that requiring the original derivative plaintiffs to have owned BofA shares at the time of the alleged wrongdoing would misapply the contemporaneous ownership requirement. The derivative plaintiffs were enforcing BofA's post-merger right, as 100 percent owner, to pursue Merrill Lynch's pre-merger claim. "Just as BofA is not required to have owned Merrill Lynch shares at the time of the alleged wrongdoing, neither are the plaintiffs required to have owned BofA shares at that point in time. It suffices that the plaintiffs own shares of BofA at the time they seek to proceed double derivatively on its behalf."

The court emphasized that a "post-merger double derivative action is not a de facto continuation of the pre-merger derivative action," but "a new, distinct action in which standing to sue double derivatively rests on a different temporal and factual basis—namely, the failure of the BofA board, post-merger, to enforce the premerger claim of its wholly-owned subsidiary."

Creditors' Derivative Standing

Last month, the Delaware Court of Chancery in *CML V, LLC v. Bax*,[6] declined to extend to limited liability companies the creditor derivative standing rule applicable when corporations are insolvent, holding that a creditor of an insolvent LLC lacks standing to maintain a derivative suit in the name of the LLC against its managers. JetDirect provided private jet services through its subsidiaries. The plaintiff creditor, CML V, LLC, loaned JetDirect $34 million, and after JetDirect became insolvent CML sought to allege breach of fiduciary duty claims derivatively on behalf of JetDirect against its board of managers.

The Court of Chancery dismissed the suit for lack of standing. Noting that "many have assumed that creditor derivative standing exists" in the LLC context, the court disagreed and held that while the Delaware Limited Liability Company Act "creates a statutory right to bring a derivative action," the plain language of §18-1002 of the act limits derivative standing to members and assignees of LLCs.

What of *North Am. Catholic Educ. Programming Found. Inc. v. Gheewalla*,[7] in which the Delaware Supreme Court held that when a corporation is insolvent its creditors take the place of the shareholders as the residual beneficiaries of any increase in value and can assert derivative claims? *Bax* bolstered its conclusion that *Gheewalla's* grant of derivative standing to creditors of insolvent corporations has no application in the LLC context by comparing §18-1002 with its corporate counterpart, section 327 of the Delaware General Corporation Law (DGCL).

Unlike §18-1002, which explicitly limits derivative standing to LLC members or their assignees, section 327 of the DGCL, which addresses derivative standing in the corporate context, contains no similar language denying derivative standing to creditors. Section 327, the court observed, leaves open the possibility that a corporate constituency other than equity holders, such as creditors, may maintain derivative claims. The difference between the statutes suggests a conscious decision by the Delaware Legislature to depart from the corporate model and confine derivative standing to LLC members or their assignees.

The court indicated in dicta that the flexibility of the LLC mechanism could permit a creditor to negotiate into an LLC agreement "duties triggered by insolvency that would include an obligation to preserve assets for creditors." Nor does *Bax* affect §18-502(b) of the LLC Act's authorizing a creditor that extends credit to an LLC in reasonable reliance on a member's obligation (i) to contribute capital to the LLC or (ii) to return a distribution in violation of the LLC Act, to enforce an LLC member's obligation to make a capital contribution to the LLC.

Endnotes:

1. *Parfi Holding AB v. Mirror Image Internet Inc.*, 954 A.2d 911 (Del. Ch. 2008).
2. 2010 WL 3563108 (E.D. Pa. Sept. 9, 2010).
3. 2010 WL 4119242 (D. Mass. Oct. 20, 2010).
4. 3 A.3d 277 (Del. 2010).
5. 2004 WL 3029876 (Del. Ch. Dec. 20, 2004).
6. 6 A.3d 238 (Del. Ch. 2010).
7. 930 A.2d 92 (Del. 2007).