DECEMBER 2012

DELAWARE UPDATE: IMPACT OF DERIVATIVE ACTION DISMISSALS ON ABSENT SHAREHOLDERS

Concerned that absent shareholders would be unfairly prejudiced, courts have been reluctant to dismiss with prejudice inadequately pleaded derivative actions. In a recent decision, however, Vice Chancellor Travis Laster elaborated on a doctrinal basis for such dismissals that, in appropriate cases, preserves the right of absent shareholders to pursue the same derivative claim. *South v. Baker*, C.A. No. 7294-VCL (Del. Ch. Sept. 25, 2012). The *South* decision should therefore make preclusive derivative pleading dismissals more prevalent.

BACKGROUND

In 2011, the Hecla Mining Company experienced serious accidents at its "Lucky Friday" mine. These incidents resulted in federal safety citations and lowered production. Thereafter, in what Vice Chancellor Laster described as a typical "race to the courthouse," two federal securities and seven stockholder derivative actions were filed in several jurisdictions. One of these was the *South* derivative action in Delaware Chancery Court. *South* at 11.

None of the derivative cases had been preceded by the pre-litigation "books and records" inspection available under the Delaware Code. 8 Del. C. §220. Two other prospective shareholder representatives, however, had initiated pre-litigation Section 220 inspection requests. *South* at 12.

In *South*, named plaintiffs Steven and Linda South brought a so-called *Caremark* claim, alleging that the Board of Directors should have prevented the accidents. The Souths also pleaded "demand futility," claiming that any demand for remedial Board action pursuant to Rule 23.1 of the Chancery Rules would have been futile. *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996). In order to prosecute a *Caremark* action, a derivative plaintiff must plead facts indicating that the directors "knowingly caus[ed] or consciously permitt[ed]

the corporation to violate positive law, or … fail[ed] utterly to attempt to establish a reporting system or other oversight mechanism to monitor the corporation's legal compliance." *South* at 1; *accord*, *id.* at 16 ("A *Caremark* claim contends that the directors set in motion or allowed a situation to develop and continue which exposed the corporation to enormous legal liability and that in doing so they violated a duty to be active monitors of corporate performance.") To plead "demand futility," a derivative complaint must allege specific "facts establishing a sufficient connection between the corporate trauma and the board such that at least half of the directors face a substantial likelihood of personal liability." *Id.* at 17.

Applying these standards, Vice Chancellor Laster held that the Souths' complaint did not satisfy *Caremark* and demand futility requirements. *South* at 26. And, because the claim had been brought hastily without a Section 220 request to inspect Hecla's books and records—a procedure recommended under Delaware case law—the *South* court, finding no mitigating circumstances, dismissed the complaint with prejudice as to the named plaintiffs. *Id.* As Vice Chancellor Laster held, the Souths had not "provided any reason why dismissal with prejudice would not be just under all the circumstances." *South* at 27. If, for example, these plaintiffs had shown that it was unlikely that another plaintiff would be available or if a statute of limitations bar loomed, then some other remedy might have been appropriate. *Id.* at 28. Dismissal with prejudice in this case, Vice Chancellor Laster found, also "freshens the litigation environment so other plaintiffs whose lawyers … conducted a pre-suit investigation might feel that they could now lead the case." *Id.* at 28, *quoting King v. VeriFone Hldgs., Inc.*, 994 A.2d 354, 355 (Del. Ch. 2010). These rulings brought into sharp focus the issue of whether other shareholders—including those already before other courts—should be barred from prosecuting their own derivative claims.

A CLEARER STANDARD FOR DETERMINING THE SCOPE OF DISMISSALS WITH PREJUDICE

As Vice Chancellor Laster noted, there have been "good faith disagreements" among Delaware and other courts regarding the effect of a "with-prejudice" dismissal in a derivative action. *South* at 13-14 & n.3 & 28. Courts have been concerned about barring claims of absent plaintiffs—some of whom may have "carefully investigated and uncovered a meritorious claim"—simply because another shareholder hastily filed a defective complaint. *Id.* at 28-29. To avoid this harsh result, courts have resorted to lesser remedies, such as permitting the plaintiff the opportunity to replead or simply denying the offender "lead plaintiff" status. *See King v. VeriFone Hldgs., Inc.*, 12 A.3d 1140, 1151-52 (Del. 2011). These lesser sanctions, however, have not remedied the "recurring scenario" of plaintiffs "hurry[ing] to file a *Caremark* claim after the announcement of a corporate trauma … to gain control of (or a role in) the litigation." *South* at 36.

To address this continuing problem, *South*, drawing on recent Court of Chancery decisions, articulated a more predictable basis for determining whether a derivative action dismissal should bind other shareholders. The Chancery Court reasoned that a dismissal should not be binding on absent shareholders if the named derivative plaintiff has not adequately represented them. *Id.* at 31-32. Vice Chancellor Laster recognized that a presumption of inadequate representation arises where "a plaintiff files a *Caremark* claim hastily and without using Section 220 [to demand corporate books and records] or otherwise conduct[ing] a meaningful investigation." Under these circumstances, the named plaintiff presumptively "has acted disloyally to the corporation and served instead the interests of the law firm who filed suit." *Id.* at 33, *citing Louisiana Municipal Employees Retirement System v. Pyott*, 46 A.3d 313, 335-36. If not rebutted, the *South* court concluded, that presumption requires that a named plaintiff's inadequately pled *Caremark* claim be dismissed with prejudice only with regard to that particular shareholder.

Vice Chancellor Laster applied this presumption to the Souths because their *Caremark* action was filed hastily where "there was no reason to rush." As the *South* court held, "a deliberate and thorough pre-suit investigation, rather than haste, was required to further the interests of the corporation." *Id.* at 38. Vice Chancellor Laster found it critical that "had the Souths used Section 220 [to inspect Hecla's books or records] before filing, then they could have evaluated

meaningfully whether it made sense to attempt to displace the Board's statutory authority to address the fallout from the Lucky Friday mining incidents. If the books and records showed that the Board was not disabled, then the Souths and their counsel, considering the matter as self-appointed fiduciaries for the corporation, could have declined to sue."

Concluding that "[r]ather than acting in the best interests of the corporation, the Souths filed hastily because doing so served the interests of their attorneys," Vice Chancellor Laster held that they had acted disloyally and thus had inadequately represented their fellow shareholders. Accordingly, the court found that the dismissal with prejudice should not have a preclusive effect on the ability of "more diligent stockholders" to file a derivative action. *Id.* at 40. Vice Chancellor Laster reasoned "that if a different stockholder carefully investigated the events at [issue], uncovered a meritorious claim, and wished to pursue it, the potential combination of a broad preclusion rule together with all-too-predictable results of the [plaintiffs'] litigation strategy could bar the diligent stockholder from suing." *Id.* at 29.

CONCLUSION

In terms of its immediate impact, the *South* decision could be viewed as a setback for corporate defendants faced with inadequately pleaded *Caremark* derivative claims. Although the Souths' claim was dismissed with prejudice, the six other Hecla derivative actions were permitted to proceed.

On the other hand, there are several reasons why Vice Chancellor Laster's opinion may have a tranquilizing effect on the filing and prosecution of *Caremark* claims. First, by reducing the uncertainty surrounding this issue, *South* will encourage more dismissals with prejudice of inadequately pled *Caremark* claims. In and of itself, that should, in Vice Chancellor Laster's words, "distill from the [multiclaim, multijurisdictional] chaos some degree of procedural order." *South* at 12.

Second, in order to avoid dismissal of their own actions, well-advised *Caremark* plaintiffs will no longer file suit absent a prior Section 220 books and records investigation. This requirement will reduce the number of derivative actions whose only purpose is to seek "lead counsel" priority in the "race to the courthouse" following a corporate trauma of one sort or another.

Third, by requiring the plaintiffs' bar generally to proceed only with investigated and more substantial *Caremark* claims, any resulting complaint will necessarily be subject to increased scrutiny on a motion to dismiss. Plaintiffs should not be able to claim, as they do now, that a relaxed pleading standard is required in the absence of discovery.

Finally, Vice Chancellor Laster's analysis of a *Caremark* plaintiff's (and his or her lawyers') fiduciary duties seems to impose new obligations on derivative plaintiffs:

> *Caremark* claims are difficult to plead and harder to prove. Equally important, because the claims are premised on corporate liability, pursuing a *Caremark* claim during the pendency of the underlying litigation or governmental investigation may well compromise the corporation's position on the merits, thereby causing or exacerbating precisely the harm that the *Caremark* plaintiff ostensibly seeks to remedy. A well-motivated derivative plaintiff, generally concerned about the corporation's best interests, will consider these factors and act carefully, not precipitously.

South at 38. This newly identified factor may itself be a new ground for dismissing *Caremark* claims.

In short, while the immediate result of *South* was to permit the other Hecla derivative actions to proceed, Vice Chancellor Laster may have promoted a more important goal—the long-term reduction of unsupported derivative claims.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Louis A. Chaiten
Cleveland
+1.216.586.7244
lachaiten@jonesday.com

Walter W. Davis
Atlanta
+1.404.581.8517
wwdavis@jonesday.com

Michael L. Davitt
Dallas
+1.214.969.2938
mldavitt@jonesday.com

James P. Dougherty
Cleveland
+1.216.586.7302
jpdougherty@jonesday.com

Philip Le B. Douglas
New York
+1.212.326.3611
pldouglas@jonesday.com

Robert S. Faxon
Cleveland
+1.216.586.7104
rfaxon@jonesday.com

N. Scott Fletcher
Houston
+1.832.239.3846
sfletcher@jonesday.com

William S. Freeman
Silicon Valley
+1.650.687.4164
wfreeman@jonesday.com

Lyle G. Ganske
Cleveland
+1.216.586.7264
lganske@jonesday.com

Thomas S. Jones
Pittsburgh
+1.412.394.7924
tsjones@jonesday.com

Eric Landau
Irvine
+1.949.553.7517
elandau@jonesday.com

Andrew M. Levine
New York
+1.212.326.8319
amlevine@jonesday.com

Robert C. Micheletto
New York
+1.212.326.3690
rmicheletto@jonesday.com

Robert A. Profusek
New York
+1.212.326.3800
raprofusek@jonesday.com

Geoffrey J. Ritts
Cleveland
+1.216.586.7065
gjritts@jonesday.com

John C. Tang
San Francisco
+1.415.875.5892
jctang@jonesday.com

Patricia J. Villareal
Dallas
+1.214.969.2973
pjvillareal@jonesday.com

Ashley E. Behan
New York
+1.212.326.3422
aebehan@jonesday.com

Marjorie P. Duffy
Columbus
+1.614.281.3655
mpduffy@jonesday.com