

OUTSIDE COUNSEL

Expert Analysis

Deference When Board Refuses Shareholder Litigation Demand

Basic tenets of corporate law entrust the corporate board with the power to make decisions on the corporation's behalf, including the power to decide whether (and when) to initiate litigation.¹ As a result, when a shareholder believes the corporation should take legal action, the shareholder must make a demand on the board, asking the board to investigate and consider taking the requested action. If, however, "the directors are deemed incapable of making an impartial decision regarding the pursuit of the litigation" and making a demand would, thus, be futile, the demand requirement will be excused, and the shareholder may pursue litigation derivatively on the company's behalf.² Delaware law imposes stringent requirements on plaintiffs seeking to establish demand futility, however, because a shareholder derivative suit "inherently impinges upon the directors' power to manage the affairs of the corporation."³

Under this well-established corporate governance regime, a shareholder who believes the company should pursue claims has two options: (1) make a demand and entrust the matter to the board's judgment or (2) bring a shareholder derivative suit and attempt to meet the high standard to demonstrate demand futility. In some cases, however, shareholders try to have it both ways, demanding that the board investigate a potential claim and then seeking to sue on the company's behalf after the board has declined to sue, by alleging that the board wrongfully refused the demand.

The Delaware Chancery Court's recent decision in one such "demand refused" case brought by a DuPont share-holder—



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*Ironworkers District Council of Philadelphia & Vicinity Retirement & Pension Plan v. Andreotti*⁴—confirms that, once a shareholder has made a demand on the board, the courts will not disturb the board's decision without particular allegations demonstrating that the decision itself was made in bad faith. The court stressed that the inquiry in a demand-refused case focuses on the board's process of investigating the demand, not on the conduct underlying the demand or on the substantive outcome of the board's investigation. The *Andreotti* decision provides strong support for corporate boards exercising their business judgment when making litigation decisions on behalf of the corporations they manage.

In its decision, the court approvingly discussed the DuPont board's process—in which the board appointed an independent committee represented by independent counsel, the committee conducted an extensive investigation and produced a detailed report of its findings and recommendations, and the board made its decision in reliance on the report—as evidence that the board's decision was informed and made in good faith.

Thus, while a board need not follow any particular process in response to a shareholder demand, the *Andreotti* decision also provides useful guidance for boards (and their counsel) seeking to ensure that their responses to shareholder demands are not vulnerable to subsequent legal challenges.

Background

The *Andreotti* decision arose from litigation between DuPont and Monsanto, in which a jury found DuPont liable for \$1.2 billion for violating a patent licensing agreement with Monsanto and infringing on Monsanto's patents. The court sanctioned DuPont, ordering it to pay Monsanto's attorney' fees for fabricating its defense and "work[ing] a fraud on the court." *Id.* at *1. An appellate court subsequently affirmed the sanctions order and found that DuPont had litigated in bad faith. *Id.*

Several DuPont shareholders then made demands on the board to investigate and consider suits against officers and directors responsible for the breaches of the company's agreement with Monsanto and its conduct during the Monsanto litigation. DuPont's board appointed a special committee of independent directors to investigate the demand while retaining ultimate authority to act with respect to the demand. The special committee retained independent counsel and, after an extensive investigation, released a report detailing its findings. In its report, the independent committee concluded that it was not in the company's best interests to pursue litigation and recommended that the board reject the shareholders' demands in full. The board adopted the committee's recommendation and rejected the demand.

A shareholder then sued, alleging wrongful refusal of the demand. In the *Andreotti* decision, the Delaware Chancery Court granted DuPont's motion to dismiss the shareholder complaint, holding that the plaintiff failed to establish standing to sue on the company's behalf.

Deference

The Chancery Court's decision turned on the distinction between the standards for pleading shareholder derivative standing

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in a "demand-excused" case (i.e., when the plaintiff argues that that demand requirement should be excused as futile) and a "demand-refused" case (i.e., when the shareholder seeks to proceed derivatively after a demand has been made and refused). A shareholder can establish derivative standing in a demand-excused case by pleading facts raising a reasonable doubt that either (1) "the directors are disinterested and independent" or (2) "the challenged transaction was otherwise the product of a valid exercise of business judgment."⁵

But, as the court explained in *Andreotti*, "[w]here... a plaintiff has made a demand on the board, the analysis and legal standards applicable are 'necessarily different' from the case where a plaintiff is alleging demand would be futile."⁶ By making a demand on the board, a shareholder plaintiff "tacitly concedes the independence of a majority of the board to respond."⁷ As a result, "[w]here the board considers a demand, and determines that pursuit of the litigation demanded is not in the corporate interest, the stockholder thereafter lacks standing to bring the litigation derivatively, unless the board's refusal is wrongful; that is, *the refusal itself is in breach of the directors' fiduciary duties.*"⁸

In *Andreotti*, the plaintiff alleged that "[t]he committee's recommendation to reject Plaintiffs' Demand outright[,] and the 'facts' and conclusions that underlie it, raise a reasonable doubt as to the reasonableness and good faith nature of the committee's investigation and recommendation and the board's vote thereon."⁹ In essence, according to the plaintiff, "liability [was] so clear and [the claim] so valuable... that a decision not to pursue the claim must have been made in bad faith."¹⁰

The court refused to second-guess the substance of the board's decision, even under the extraordinary circumstances of the case. The board decided not to pursue a claim and determined that the company pursued the Monsanto litigation in good faith (and that the trial court's order of sanctions was a result of "an error in judgment by the court"), despite a jury finding of misconduct resulting in a judgment against the company and an appellate ruling affirming imposition of sanctions.¹¹ As the Chancery Court explained, the relevant question was not whether the board's decision to refuse the demand was "wise or foolish," but whether it was "taken in good faith and absent gross negligence."¹²

The court noted that "mere disagreement with the committee's ultimate conclusion...

will be insufficient to raise a reasonable doubt that the board acted in good faith and on an informed basis."¹³ The court explained that "[t]he decision to bring litigation on behalf of a corporation is a quintessential exercise of business judgment, involving as it does a complex array of costs (both monetary and otherwise), potential benefits, and the risk of uncertain outcomes."¹⁴

In light of the unusual circumstances of the case, the Chancery Court's decision in *Andreotti* is a strong statement that courts will not second guess the ultimate conclusions of boards and special committees, so long as their decisions are made in good faith and on an informed basis.

Independent Committee

In determining that DuPont's board had acted in good faith, the Chancery Court relied heavily on the process the board followed, including forming an independent committee, which "hired well-regarded independent counsel to assist in its investigation, and over the course of nine months vigorously investigated the circumstances alleged in the stockholder demands, including interviewing 23 witnesses, reviewing hundreds of documents, reviewing 25 days of deposition testimony and the entirety of the Monsanto litigation transcript, and conducting additional research."¹⁵ At the conclusion of this process, the committee presented its findings and recommendations to the full board in a 179-page report, which the board considered and adopted. Based on this record, "no successful argument [could] be made that the board was uninformed" in its decision.¹⁶

The court noted that, under different circumstances, the "failure to conduct a thorough investigation could, if sufficiently egregious, support a reasonable inference of gross negligence."¹⁷ Thus, notwithstanding the deference shown to the substance of the board's decision, the *Andreotti* decision makes clear that the courts will scrutinize a board's process in considering a demand, underscoring the importance of conducting an appropriate investigation of any shareholder demand.

Of course, not every shareholder demand warrants the expense of creating a special committee, retaining independent outside counsel, or preparing a detailed written report. But boards and their counsel should carefully consider whether each of these steps is appropriate in any given case in order for the board to fulfill its duties.

Ultimately, the board must ensure that it is adequately informed in making its decision and should ensure that it has developed a record demonstrating that its decision was adequately informed.

Courts will view a board's decision to form a special committee with independent counsel as a sign that the board attempted in good faith to make an informed decision. And when a board chooses to inform itself by appointing an independent committee and relying on the committee's findings and recommendations, the board will "benefit from the *presumption* of a proper exercise of business judgment" in doing so.¹⁸

Endnotes:

1. *See Kamen v. Kemper Servs.*, 500 U.S. 90,101 (1991) (recognizing the "basic principle of corporate governance that the decisions of a corporation—including the decision to initiate litigation—should be made by the board of directors" (quotations omitted)).

2. *Beam v. Stewart*, 845 A.2d 1040, 1048 (Del. 2004); New York law has a similar demand requirement. *See* N.Y.B.C.L. § 626(c); *Bansbach v. Zinn*, 801 N.E.2d 395, 401 (N.Y. 2003).

3. *Kaplan v. Peat, Marwick, Mitchell & Co.*, 540 A.2d 726, 730 (Del. 1988).

4. C.A. No. 9714-VCG, 2015 WL 2270673 (Del. Ch. May 8, 2015).

5. *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984).

6. 2015 WL 2270673, at *24.

7. *Id.*

8. *Id.* (emphasis added).

9. *Id.* at *13.

10. *Id.* at *26.

11. *Id.* at *19.

12. *Id.* at *26; *see also id.* at *27 ("Demonstrating that directors have breached their duty of loyalty by acting in bad faith goes far beyond showing a questionable or debatable decision on their part.").

13. *Id.* at *27.

14. *Id.* at *24.

15. *Id.* at *26.

16. *Id.*

17. *Id.* at *26 n.255.

18. *Id.* at *27 (emphasis in original); *see also id.* ("[O]nly where a board has reason to doubt that a committee's report is a good faith and informed recommendation can I infer breach of duties arising from that board's reliance on the report.").