DIRECTORS' AND OFFICERS' LIABILITY
DISTINGUISHING BETWEEN DERIVATIVE AND DIRECT CLAIMS

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JANUARY 13, 2002

Is the claim derivative or direct? The question has vexed courts and practitioners in Delaware and elsewhere as they have sought to clarify the "often murky distinction" between the two types of corporate law claims.[1] The hazy line between the claims can become even more indistinct when it is understood that the same facts can give rise to both a derivative claim and a direct claim. Yet as Vice Chancellor Leo Strine's recent decision in *Akins v. Cobb* illustrates,[2] characterizing a claim as derivative or direct carries important procedural and substantive law consequences, and may determine whether the claim may proceed at all.

What's At Stake

A derivative claim seeks to enforce an alleged right belonging to a corporation that the corporation has declined to assert. Characterizing a claim as derivative immediately alters the playing field on which the claim will be litigated. Most significantly, a shareholder prosecuting a derivative suit cannot take advantage of the liberal pleading standards of Rule 12(b)(6). Instead, under Chancery Court Rule 23.1, the shareholder suing derivatively must allege either that the board rejected his or her pre-suit demand to bring the claim or allege with particularity why a demand would have been futile. To properly allege futility, the shareholder must allege facts creating a reasonable doubt either that: (1) the directors are disinterested and independent or (2) the challenged transaction otherwise was the product of a valid exercise of business judgment.[3] The first element examines the interestedness of the board at the time the action was commenced, and the second element evaluates the informational component of the board's approval of the challenged transaction, measured by principles of gross negligence. The particularity requirement of Rule 23.1 is a formidable hurdle to surmount where a majority of the board is disinterested and independent in the challenged transaction. Moreover, demand is not excused simply because each director is named in the suit, and absent specific allegations of self-dealing or bias, a plaintiff cannot automatically disqualify all directors simply because each of them approved or acquiesced in the challenged transaction.[4] Allegations of controlling stock ownership by the board do "not raise, *per se*, a reasonable doubt as to the board's independence."[5] Thus, demonstrating demand futility is difficult, and the board's decision not to pursue a derivative claim ordinarily is evaluated under the business judgment rule and its accompanying presumptions.

Even in a demand-excused case, the board may reassert its authority over a derivative claim in certain circumstances through a Special Litigation Committee of disinterested directors. Under the *Zapata* rule, the court may dismiss the action upon the committee's recommendation not to pursue the claim if the corporation establishes that the committee is independent, and conducted a good faith, reasonable investigation of the claim.[6] Direct actions (whether proceeding individually or on a class basis) may not be dismissed based on the recommendation of a Special Litigation Committee.

Although Chancery Court Rule 23.1 does not expressly include an adequacy requirement, Delaware law holds that a derivative plaintiff is a fiduciary to the corporation and its shareholders and therefore must be able to adequately represent their interests. And like a class action, a derivative claim may not be settled without court approval.

From the defense perspective, characterizing a claim as derivative may trigger conflict issues when management prefers to have the same counsel represent the corporation and any director defendants. Courts have questioned the propriety of joint representation out of concern that "[i]f the same counsel represents both the corporation and the director and officer defendants, the interests of the corporation are likely to receive insufficient protection. An increased recovery for the corporation is wholly incompatible with the goal of limiting the defendants' liability."[7] While the Delaware courts have declined to hold dual representation *per se* improper, sufficiently serious concerns have been raised about the potential for divergent interests that retention of separate counsel is advisable to avoid distracting allegations of conflict.[8]

Categorizing the Claim

In Delaware and elsewhere, the distinction between a derivative and direct claim turns on the nature of the wrong alleged in the complaint regardless of the plaintiff's designation. In order to assert a direct claim, a plaintiff must allege more than an injury resulting from a wrong to the corporation. Rather, a shareholder has a direct claim only if the alleged injury was peculiar to a specific class of shareholders or peculiar to shareholder interests as opposed to the corporation's. Thus where a corporation sustains the alleged injury and the shareholders suffer solely through a reduction in the value of their stock, the claim belongs to the corporation and must be asserted derivatively.

The Court of Chancery ruled in the seminal decision of *Elster v. American Airlines, Inc.*,[9] that a shareholder has an individual claim against the corporation if he has sustained a "special injury," which the Court suggested was "a wrong inflicted upon him alone or a wrong affecting any particular right which he is asserting, -- such as his preemptive rights as a stockholder, rights involving the control of the corporation, or a wrong affecting the stockholders and not the corporation." While the Delaware Supreme Court has declined to limit "special injury" to any specific meaning, it has repeatedly reaffirmed the test of a direct claim requiring a plaintiff to "allege either an injury which is separate and distinct from that suffered by other shareholders, or a wrong involving a contractual right of a shareholder, such as the right to vote, or to assert

majority control, which exists independently of any right of the corporation."[10] In essence, the distinction between derivative and direct claims rests on (a) whether the alleged wrong is to the corporation or to the shareholders and (b) whether the corporation or the shareholders should receive relief.

A simple example illustrates the distinction. If the board of directors of a company approves the sale of a fleet of brand new trucks at a fire sale price as a favor to the Chairman's brother-in-law, the breach of fiduciary duty (*e.g.*, mismanagement, waste) would injure the corporation as a whole and all of its stockholders on a pro rata basis. The breach would deplete corporate assets and thereby injure shareholders only indirectly, by reason of the direct injury to the corporation, which now has fewer assets. An action to recover the value of the trucks should be brought in the name of the corporation for the benefit of the corporation -- not for the shareholders' direct benefit. While mismanagement may cause the corporation's stock to decline in value or even result in insolvency, shareholders cannot recover in their individual capacities because their loss is the indirect, *i.e.*, derivative result of the injury to the corporation. Recovering the assets for the corporation would redress the injury; payment of damages directly to the plaintiff-stockholders for reduction in the value of their stock would be a windfall. Thus, "a claim alleging corporate mismanagement, and a resulting drop in the value of the company's stock, is a classic derivative claim; the alleged wrong harms the corporation directly and all of its stock holders indirectly."[11] Claims of waste, self-dealing, and excessive compensation typically are derivative because any injury flowing from such wrongs is shared ratably among all shareholders.

Conversely, an alleged breach of fiduciary that frustrates or deprives a shareholder of an attribute of share ownership gives rise to a direct action. If directors were to exclude certain shareholders from voting, or propose a merger, stock redemption or recapitalization that impaired minority shareholders rights, the aggrieved shareholders would have a direct claim against the directors.[12] Similarly, allegations challenging stock dilution and a corresponding reduction in a shareholder's voting power constitute a direct claim.[13]

The characterization of shareholder claims challenging defensive takeover measures has proved difficult. Challenges to defensive takeover measures typically allege an entrenchment claim, which may be direct or derivative (or both) depending on the allegations. An entrenchment claim is direct when the alleged entrenching activity directly impairs an incident of share ownership, such as a voting right.[14] For example, in *Carmody v. Toll Bros., Inc.,*[15] the Court of Chancery held that a challenge to a "dead hand" poison pill rights plan – one that cannot be redeemed except by the incumbent directors who adopted the plan or their designated successors -- constituted a direct claim. The Court reasoned that the "dead hand" provision at issue effectively disenfranchised any shareholders in a proxy contest who wished to have the company managed by directors empowered to redeem the rights plan, because such shareholders would have no practical choice but to vote for the incumbents. There is authority, however, that an entrenchment challenge to a rights plan commenced at a time when no shareholder has launched a proxy contest must be asserted derivatively; "[b]ecause the

plaintiffs are not engaged in a proxy battle, they suffer no injury distinct from that suffered by other shareholders as a result of this alleged restraint on the ability to gain control . . . through a proxy contest."[16]

The same facts may spawn direct and derivative claims.[17] If a board authorized the issuance of common stock and sold it to someone who had promised to keep the board in office, shareholders would have a direct entrenchment claim because the stock issuance threatens to dilute their voting power. If the same stock were issued for patently inadequate consideration, however, the facts would also give rise to a claim of waste of corporate assets, and that claim would belong to the corporation and could be asserted by a shareholder only derivatively.

The characterization of claims arising out of mergers is a recurring subject of threshold dispute because the designation of a merger-related claim asserted by a target-company shareholder as derivative usually results in immediate dismissal of the claim for lack of standing. Because a shareholder suing derivatively asserts a corporate claim, not a personal one, and "to prevent windfalls to plaintiffs who have accepted the benefits of a corporate transaction extinguishing their ownership of stock,"[18] Delaware courts require that the plaintiff be a shareholder of the allegedly aggrieved corporation both when the suit is commenced *and* throughout the litigation.[19] At commencement, a purchaser of stock qualifies to serve as a shareholder plaintiff upon settlement of the trade.[20] Upon consummation of a merger, shareholders in the target company generally are cashed-out and lose their status as shareholders. As the Court of Chancery recently observed, "[t]he practical consequence of that teaching in the merger context is that the [derivative] claims against [target company directors] are usually extinguished, because the target stockholders cashed-out in the merger lose standing and because arms-length acquirors rarely press claims against the departing executives of targets they acquire in friendly transactions."[21] Delaware recognizes a limited exception to the rule that a merger eliminates target shareholder standing, where the merger is merely a reorganization that does not affect the plaintiff's ownership interests.[22]

Certain merger-related claims are non-derivative and therefore will survive consummation of the merger. Delaware law recognizes a direct claim when a shareholder challenges the fairness or validity of a merger, typically by alleging that breaches of fiduciary duty by the directors of the target company resulted in unfair dealing tainting the merger negotiation process and/or an unfair acquisition price. Decisions separating challenges to the merger itself (direct claims) from alleged wrongdoing associated with the merger (derivative claims) have to some extent clarified the characterization of claims in change of control transactions. In *Kramer v. Western Pacific Indus.*,[23] the Delaware Supreme Court held that allegations that a target company's directors breached their fiduciary duties by awarding management excessive compensation in the form of employment benefits in connection with a merger and stock benefits in connection with a merger constituted a derivative claim for mismanagement. Although the plaintiff alleged that the benefits and options reduced the merger consideration available to shareholders, his failure to challenge the fairness of the merger price rendered the claim derivative. In *Parnes v. Bally Entertainment Corp.*,[24] however,

the Court held that allegations that a target company's Chairman improperly controlled merger negotiations by demanding that any potential acquiror make cash and asset payments to him constituted a direct claim because allegedly self-interested negotiations may have resulted in an unfair merger price.

In *Akins v. Cobb,* Vice Chancellor Strine recently considered a claim for breach of fiduciary duty relating to compensation packages awarded by the board to three senior members of management to incentivize their performance while liquidating the company. The complaint did not allege that the compensation packages compromised the terms negotiated in liquidating company assets. Rather, the allegedly excessive compensation caused a balance sheet injury by reducing the amount of funds available for distribution in the liquidation – harm that would fall equally on shareholders in proportion to their holdings. Characterizing the claim as derivative, the Court dismissed the complaint because it failed to provide particularized facts establishing either demand excusal or reasonable doubt concerning the board's decision-making process.

Conclusion

The procedural and substantive ramifications of characterizing a claim as derivative as opposed to direct warrant careful assessment of the nature of the injury alleged and the relief sought by shareholder claims challenging director and officer conduct. The line of distinction between the claims is often narrow, but the principles gleaned from case law provide a measure of predictability. If the claim may be characterized as derivative, the deference accorded to directors' decisions under the business judgment rule will be a formidable hurdle to a successful challenge to director conduct.

ENDNOTES

[1] *In re Cencom Cable Income Partners, L.P. Litig.*, 2000 WL 130629, *3 (Del. Ch. January 27, 2000).

[2] 2001 WL 1360038 (Del Ch. Nov. 1, 2001).

[3] *Brehm v. Eisner*, 746 A.2d 244, 256 (Del. 2000).

[4] *Id*. at 256 n.34.

[5] *Heineman v. Datapoint Corp.*, 611 A.2d 950, 955 (Del. 1992).

[6] *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).

[7] *In re Oracle Sec. Litig.*, 829 F. Supp. 1176, 1188 (N.D. Cal. 1993).

[8] *See, e.g., Scott v. New Drug Servs., Inc.*, 1990 WL 135932 (Del. Ch. 1990).

[9] 100 A.2d 219, 222 (Del. Ch. 1953).

[10] *Lipton v. News Int'l plc,* 514 A.2d 1075, 1078 (Del. 1986).

[11] *Parnes v. Bally Entertainment Corp.*, 722 A.2d 1243, 1245 (Del. 1999).

[12] *See, e.g.*, *Rabkin v. Philip A. Hunt Chem. Corp.*, 547 A.2d 963, 969 (Del. Ch. 1986).

[13] *In re Tri-Star Pictures, Inc., Litig.*, 634 A.2d 319 (Del. 1993).

[14] *Avacus Partners, L.P. v. Brian*, 1990 WL 161909 (Del. Ch. Oct. 24, 1990).

[15] 723 A.2d 1180 (Del. Ch. 1998).

[16] *Moran v. Household Int'l, Inc.*, 490 A.2d 1059, 1070 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985); *but see In re Gaylord Container Corp. Sh. Litig.*, 747 A.2d 71 (Del. Ch. 1999) (advocating a "reassessment of *Moran*").

[17] *See id.*

[18] *In re Gaylord Container Corp. Sh. Litig.*, 747 A.2d 71, 82 (Del. Ch. 1999).

[19] *See, e.g.*, 8 Del. C. § 327 ("In any derivative suit instituted by a stockholder of a corporation, it shall be averred in the complaint that the plaintiff was a stockholder of the corporation at the time of the transaction of which such shareholder complains or that such stockholder's stock thereafter devolved upon such stockholder by operation of law."); *Parnes*, 722 A.2d at 1244-45.

[20] *Avacus Partners,* 1990 WL 161909 at *6.

[21] *Akins*, 2001 WL 1360038, *6.

[22] *Lewis*, 477 A.2d at 1047 n.10. Outside of Delaware, certain courts have recognized an exception where the allegedly aggrieved corporation survives the merger as a wholly-owned subsidiary of the parent corporation. *See, e.g.*, *Blasband v. Rales*, 971 F.2d 1034, 1046 (3d Cir. 1992). *Blasband* has been rejected by Delaware courts. *See, e.g.*, *In re First Interstate Bancorp Cons. Sh. Litig.*, 729 A.2d 851, 867 (Del. Ch. 1998).

[23] 546 A.2d 348 (Del. 1988).

[24] 722 A.2d 1243 (Del. 1999).