

## **Allegations of Misconduct: Guiding the Board Through Derivative Claims and Demands**

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1. PowerPoint Presentation

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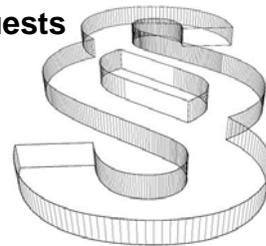
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## Outline

- Responding to a Demand
- Derivative Litigation in the Absence of a Demand
- Special Litigation Committees
- Responding to Books & Records Requests
- Insurance & Indemnification Issues



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## Responding to a Demand



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## What is a Demand?

- **Demand: pre-suit request by a shareholder on the board to bring the action on behalf of the corporation or otherwise to resolve the issues that a shareholder raises.**
  - A form of “alternate dispute resolution” that “exists at the threshold, first to insure that a stockholder exhausts his intracorporate remedies, and then to provide a safeguard against strike suits.” *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984).

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## Is the Demand Sufficient?

- **A shareholder generally must send a letter or draft complaint or other comparable communication to the board of directors.**
  - Some state statutes and Federal Rule of Civil Procedure 23.1 allow a demand to be made on someone other than the board if that party is of “comparable authority.”
- **Allows the corporation an opportunity to consider the merits of the dispute and determine, in the interests of the corporation and shareholders, whether it might be disposed of without the expense and delay of litigation.**

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## Derivative Litigation in the Absence of a Demand



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## Derivative Litigation in the Absence of a Demand

- Frequently, shareholders initiate litigation without first making demand.
- Must allege particular facts demonstrating that making such a demand would be futile. See, e.g., Del. Ch. Ct. R. 23.1; Minn. R. Civ. P. 23.09; Fed. R. Civ. P. 23.1.

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## Demand Futility

- Delaware courts apply two standards, depending upon whether allegations relate to a board action or board lack of oversight. See, e.g., *Reiter v. Fairbank*, 2016 Del. Ch. LEXIS 158, \*16 (Del. Ch., Oct. 18, 2016).
  - In matters of allegedly improper board action, plaintiffs must demonstrate reasonable doubt that (1) the directors are disinterested and independent and (2) that the decision was a valid business judgment. *Aronson v. Lewis*, 473 A.2d 805, 814-15 (Del. 1984).
  - In matters of alleged inaction or lack of oversight, plaintiffs must demonstrate “reasonable doubt that the board could have properly exercised its independent and disinterested judgment in responding to the demand.” *Rales v. Blasband*, 634 A.2d 927, 934 (Del. 1993).

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## Demand Futility

- In Minnesota, courts often cite to Delaware law and *Aronson's* demand futility language, but generally consider Minnesota's demand futility requirements to be "more stringent." See *La. Mun. Police Emp. Ret. Sys. v. Finkelstein*, 2012 Minn. Dist. LEXIS 251, \*7-8 (D. Minn., May 29, 2012).
- Because under Minnesota law boards can appoint non-directors to a special litigation committee, courts have recognized that under Minnesota law, "it is arguable that demand is never futile." *Kococinski v. Collins*, 935 F. Supp.2d 909, 917 n.13 (D. Minn. 2013).

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## Direct or Derivative, That is the Question

- Another frequent issue that arises is whether the shareholder action is "derivative" or "direct."
  - Only "derivative" shareholder actions require a demand; "direct" shareholder actions do not.
- Delaware follows the "direct harm" test
  - (1) Who suffered the alleged harm (the corporation or the shareholders, individually) and (2) who would receive the benefit of any recovery or remedy? See *Tooley v. Donaldson*, 845 A.2d 1031, 1036 (Del. 2004).
- Minnesota follows the "special injury" test
  - Whether the injury to the individual plaintiff is separate and distinct from the injury to other persons in a similar situation as the plaintiff." *Nw. Racquet Swim & Health Clubs, Inc. v. Deloitte & Touche*, 535 N.W.2d 612, 617 (Minn. 1995).

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## Direct or Derivative, That is the Question

- While test seems straightforward, application of it is not.

$$\text{Second Derivative is: } \frac{d}{dx} \left( \frac{dy}{dx} \right) = \frac{d^2y}{dx^2} = f''(x) = y''$$

$$\text{Third Derivative is: } \frac{d}{dx} \left( \frac{d^2y}{dx^2} \right) = \frac{d^3y}{dx^3} = f'''(x) = y'''$$

$$n^{\text{th}} \text{ Derivative is: } \frac{d}{dx} \left( \frac{d^{n-1}y}{dx^{n-1}} \right) = \frac{d^n y}{dx^n} = f^{(n)}(x) = y^{(n)}$$

- Minnesota Supreme Court currently considering this direct vs. derivative question in the context of shareholder action challenging M&A transaction.
  - *In re Medtronic, Inc. Shareholder Litigation*

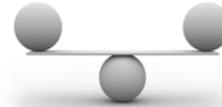
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## Responding to Demand or a Genuinely Derivative Lawsuit

- If a demand is made, the board can accept the demand and bring suit itself, or it can refuse the demand.
- The shareholder can only go through with the derivative action if the board refuses the demand and that the refusal is itself a breach of fiduciary duty.
- A special litigation committee (“SLC”) provides a vehicle for considering the demand or litigation.

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## The SLC



- **What is an SLC?**
  - A special committee of independent, disinterested directors or other independent individuals formed by the board for the purpose of investigating the merits of the proposed litigation and determining whether it is in the company's best interests to proceed with the litigation.
    - Ensures that disinterested individuals are allowed to decide how to handle the company's claim.
  - A properly created, independent SLC often defeats a shareholder's claim of futility and prevents a plaintiff from pursuing a derivative claim without the SLC's approval.

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## The SLC

### Statutory Bases for Appointing the SLC

- **Delaware:** 8 Del. Code § 141(c)
- **Minnesota:** Minn. Stat. § 302A.241, subd. 1
- **SLCs can be appointed for various types of entities**
  - Limited Liability Companies (Minn. Stat. § 322B.66)
    - See also *Obeid v. Hogan*, Del. Ch. (slip op. June 10, 2016)
  - Nonprofit Corporations (Minn. Stat. § 317A.241)
  - Cooperative Associations (Minn. Stat. § 308B.451)

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## Considerations in Forming the SLC

- An SLC must be formed with the utmost care to ensure that its members and advisers can objectively evaluate the merits of a suit and the best interests of the corporation when a board cannot.
  - Must not have interest in challenged transaction or claims at issue
  - e.g., newly-appointed directors, directors independent or disinterested in the underlying claim, or in Minnesota outside independent persons
- Board must delegate its authority to the SLC.
  - Compare *In re UnitedHealth Shareholder Litig. and Janseen v. Best & Flanagan* (MN)

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## Benefits of an SLC

- A properly constituted SLC offers an efficient and effective way to address derivative claims, even faced with board conflicts.
- A properly constituted SLC makes demand futility impossible.
- An SLC investigation often forestalls or even eliminates litigation discovery.
- An SLC's conclusion that no action should be brought will aid in (or in some states require) subsequent dismissal.
  - In Minnesota, courts will defer to a decision by an SLC in appropriate circumstances. *In re UnitedHealth Group Inc., S'holder Derivative Litig.*, 754 N.W.2d 544 (Minn. 2008).
  - In Delaware, although courts do not defer to the SLC, the SLC's investigation and conclusions provide the basis for the court's own two-part analysis of motions to dismiss. *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).

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## Privilege Issue With an SLC

- Be mindful of privilege in the SLC context.
- Assume report will be made public.
- Courts recognize a shareholders' "good cause" basis to discover the corporation's privileged information. See, e.g., *Garner v. Wolfinbarger*, 430 F.2d 1093 (5th Cir. 1970); *Ryan v. Gifford*, 2007 Del. Ch. LEXIS 168 (Del. Ch., November 30, 2007).
- Determinations of privilege and waiver can be intensely factual inquiries in shareholder litigation, balancing issues of need, alternate sources, joint defense, waiver, and similar issues. See, e.g., *Ross v. Abercrombie & Fitch Co.*, 2008 U.S. Dist. LEXIS 33018, \*23 (S.D. Ohio, April 22, 2008).

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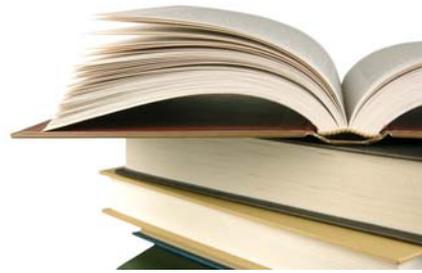
## Privilege Issues With an SLC

- Common practices seek to preserve privilege as much as possible:
  - An SLC retains its own counsel
  - Corporation counsel and SLC counsel cannot presume a joint privilege
  - Beware of the presence of advisors, accountants, and other third-parties
  - SLC investigations are typically not transcribed



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## Responding to Books & Records Requests



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## Books & Records Requests

- **Shareholders of a corporation have rights to access the books and records of the entity.**
- **A claim for inspection is a direct claim belonging to the shareholder, not a derivative claim belonging to the corporation.**



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## Books & Records Requests

- **Minnesota Law: Minn. Stat. 302A.461**
  - Shareholder’s right is subject to certain requirements of reasonableness
  - Shareholders have the right to inspect the books and records
    - Provided that the shareholder states a “proper purpose” for doing so and
    - That the documents she requests are “reasonably related to the stated purpose and described with reasonable particularity”

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## Books & Records Requests

- **Delaware Law: Del. Code Ann. Tit. 8, § 220(c) (2001 & Supp. 2010)**
  - Any stockholder shall have the right to inspect
    - The corporation’s stock ledger, list of stockholders, and its other books and records, and
    - A subsidiary’s books and records
  - Need a proper purpose – a purpose reasonably related to such person’s interest as a stockholder
  - If demand by an attorney, needs a power of attorney or similar document
  - Right to investigate and obtain corporate books and records before filing derivative litigation
  - Bifurcates the prerequisites for access depending on the type of materials requested and relies on the “proper purpose”

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## Books & Records Requests

### Case Examples

- *Saito v. McKesson HBOC, Inc.*, 806 A.2d 113, 114–15 (Del. 2002)
  - Where a § 220 claim is based on alleged corporate wrongdoing, and assuming the allegation is meritorious, the stockholder should be given enough information to effectively address the problem, either through derivative litigation or through direct contact with the corporation's directors and/or stockholders.
- *Amalgamated Bank v. Yahoo! Inc.*, 132 A.3d 752, 793 (Del. Ch. 2016)
  - Analyzes the term “books and records” in § 220 and interprets that phrasing to explicitly include emails and other electronically stored documents. Moreover, if a personal email account was used by a director or officer to conduct corporate business, those emails may also be subject to production. This extends to texts and social media posts as well.

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## Insurance & Indemnification Issues Another Minefield



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## Insurance Issues

- **Timely Notice**
  - Pay attention to policy periods
  - D&O policies “claims made” or “claims made and reported”
  - Claim must be both made against the insured and reported to the insurer during the policy period for coverage to apply:

THIS POLICY IS WRITTEN ON A *CLAIMS MADE AND REPORTED* BASIS AND COVERS ONLY CLAIMS FIRST MADE AGAINST THE INSURED DURING THE POLICY PERIOD OR THE EXTENDED REPORTING PERIOD, IF APPLICABLE, AND REPORTED IN WRITING TO THE INSURER PURSUANT TO THE TERMS HEREIN

- First order of business – report the claim

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## Insurance Issues

- **Rescission – Upon receipt of notice Carriers may rescind**
  - Problem is particularly acute in cases involving restatements of a company's financial statements
  - Rescission is based on misrepresentations in application process; voids coverage entirely. See, e.g., *ClearOne v. National Union*, 494 F.3d 1238 (10th Cir. 2007)
  - Application process requires the company's most recent Form 10-K, interim financials, and certification that the financials are true and correct and “the Applicant ... has [no] knowledge or information of any act, error or omission which might give rise to a Securities Claim.”

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## Insurance Issues

- **Severability/Imputation of Knowledge**
  - Absent a severability provision, a misrepresentation or act of misconduct by any Director can cause all insureds to lose their coverage.
  - Severability clauses preserve insurance coverage for innocent directors and officers, despite any improper conduct by other insureds.
    - e.g., “It is further agreed that ... any knowledge possessed by any Insured (other than the knowledge and/or information possessed by the person(s) executing the application) shall not be imputed to any other Insured Person; only facts pertaining to and knowledge possessed by any past, present or future chairman of the board, president, chief executive officer [CEO], chief operating officer [COO], chief financial officer [CFO] and General Counsel ... of the Organization shall be imputed to the Organization. . . .”

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## Insurance Issues

- **Exclusions:**
  - **Insured v. insured exclusion:** excludes coverage for claims “made against any Insured brought or maintained by or on behalf of the Company or any Insured Person in any capacity.”
    - Derivative claims? Usually excluded from the exclusion.
    - Claims by bankruptcy trustee? Creditors’ committee?
  - **Personal profit:** excludes coverage for claims based on “remuneration, profit or other advantage to which the Insured was not legally entitled.”
    - SOX 304? In the event of a restatement, requires CEO and CFO to disgorge any bonus or other incentive-based or equity-based compensation and any profits realized from the sale of securities of the issuer during that 12-month period.
    - Sections 11, 12 or 15 of the Securities Act of 1933 – uninsurable because amount to ill-gotten gains; negotiate out.

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## Insurance Issues

- **Exclusions, cont'd:**
  - **Fraudulent conduct:** excludes coverage for criminal or fraudulent acts by the Insured;
    - Usually requires “final, non-appealable adjudication in any action or proceeding,” but may require only “adverse finding of fact,” or “adverse admission by, or plea of nolo contendere or no contest”
  - **Regulatory investigations and criminal investigations:** when do you get coverage?
    - Usually requires return of an indictment or information
    - None of the following *very expensive legal matters* is covered :
      - Subpoena from regulator
      - Testimony before a regulator
      - Criminal investigation/target letter
    - *But see, MBIA v. Fed. Ins. Co.*, 652 F.3d 152 (2d Cir. 2011) (NYAG subpoena was a “Securities Claim”)

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## Insurance Issues

- **Demand Investigation Sublimits**
  - Pay attention both to insuring agreement and defined term
  - “First dollar” coverage
    - Particularly important to provide prompt notice
  - Separate sublimit, but erodes overall policy limits
  - Typically does not erode retentions/deductible



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## Insurance Issues

- **Demand Investigation Coverage Issues**
  - Who and what is covered?
  - “Reasonable” Fees
    - The SLC process permits very little or no control or oversight
    - Attempts to apply “litigation guidelines”
  - Allocation between litigation and investigation
  - Successful SLC investigation as the “defense” to litigation
    - Motion to Stay
    - Motion to Dismiss by the SLC or after SLC investigation

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## Indemnification Issues

- **Mosaic of authorities**
  - Corporate code (state of incorporation)
    - Significant differences in state law
    - Delaware
    - Minnesota
    - Revised Model Business Corporation Act
  - Federal law limits
    - Securities laws
    - S&Ls – 12. C.F.R. § 545.121 (limits on indemnification)
    - FDIC insured – 12 U.S.C. §1828(k); 12 C.F.R. § 359.1(l) (no indemnification for civil money penalties)
  - Articles and by-laws
  - Employment agreements and other contracts



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## Indemnification Issues: Advancement

- **Advancement:** paying defense expenses (attorneys' fees) incurred by an officer or director of the corporation *in advance of the final disposition* of such action, suit or proceeding
- **Must the Company advance expenses?**
  - Delaware & RMBCA – permissive
  - Minnesota – mandatory, if requirements are met
- **Timing** – decision is made very early before the proceeding is completed.



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## Indemnification Issues: Advancement

- **Board decision that standard of conduct has been met?**
  - Delaware? No, just a credit/treasury decision.
  - Minnesota? Yes, based on “the facts then known.”
- **Who makes the decision to advance?**
  - Fiduciary duty: business judgment rule or “entire fairness”
  - New litigation over advancement decision
- **Prerequisite of an “undertaking” by indemnitee?**

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## Indemnification Issues: Indemnification

- **Indemnification:** the right to be reimbursed for losses (including defense costs) that were incurred in legal proceedings related to their job responsibilities.
- **Permissive or mandatory?**
  - Delaware & RMBCA – permissive
  - Minnesota – mandatory, if requirements are met
- **Standard of conduct:** indemnitee must have “acted in good faith and in a manner the person *reasonably believed* to be in or not opposed to the best interests of the corporation.”
  - Special rules for (i) criminal cases; (ii) actions *by the corporation* (direct, derivative, receiver, or trustee) [Delaware and Minnesota are significantly different]; and (iii) actions regarding employee benefit plans.
  - Effect of adverse determination in underlying proceeding

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## Indemnification Issues

- **What “proceedings” trigger a right to indemnification?**
  - “any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative,” Del. § 145(a), but
    - Grand jury subpoena?
    - Target letter?
    - Internal investigation?
    - Arbitration?



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## Indemnification Issues

- **What “losses” are covered?**
  - “Expenses (including attorneys’ fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by the person in connection with such action, suit or proceeding.” Del. § 145(a).
  - Special rules for derivative actions in Delaware
    - Expenses only
    - None at all if you lose, unless awarded by the Court. Del. § 145(b)
  - Federal and public policy limits
    - Indemnification for federal securities laws violations is against public policy. *Globus v. Law Research Service, Inc.*, 418 F.2d 1276 (1969).
    - FDIC/SEC limits

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## Indemnification Issues

- **Attorneys’ fees in advancement and indemnification litigation**
  - RMBCA: allows attorneys’ fees in actions seeking to enforce advancement, permissive indemnification, and mandatory indemnification rights
  - Delaware: Does not
  - Minnesota: Does not, but if indemnitee is a shareholder §302A.467 applies and allows. See *Augustine v. Arizant Inc.*, 2008 WL 5396706, at \*4 (Minn. Ct. App 2008) (on remand).

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## Indemnification Issues

- **Mandatory indemnification: significant jurisdictional differences**
  - Delaware: indemnification is mandatory if the indemnitee has been successful
    - “on the merits or otherwise”
    - “in defense of any action, suit . . . or in defense of any claim, issue or matter therein”
  - RMBCA:
    - Indemnitee must be “wholly successful, on the merits or otherwise, in the defense of any proceeding”
  - Minnesota: None

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Questions?



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