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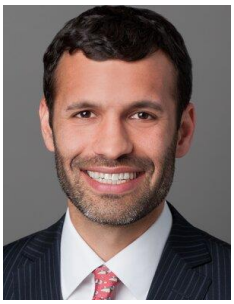
2 New Defenses To Federal Shareholder Derivative Claims

By **Brian Lutz and Michael Kahn** (June 15, 2022, 6:15 PM EDT)



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In recent years, shareholder derivative plaintiffs increasingly have been asserting claims against directors and officers under the federal securities laws, expanding beyond the traditional state law breach of fiduciary duty claims that long have been the foundation of derivative suits.

These claims typically are brought under Section 14(a) of the Securities Exchange Act, which prohibits misleading statements in proxy materials.

Plaintiffs presumably are bringing Section 14(a) derivative claims because, unlike many breach of fiduciary duty claims, they typically only require proof of negligence, not scienter.

Plaintiffs also appear to be pursuing federal claims in derivative cases in an attempt to avoid forum selection provisions in corporate charters and bylaws, which frequently designate the Delaware Court of Chancery as the exclusive forum for derivative actions.

Indeed, in just the last few months, the U.S. Court of Appeals for the Seventh Circuit, in Seafarers Pension Plan v. Bradway, and the U.S. Court of Appeals for the Ninth Circuit, in Lee v. Fisher, have addressed plaintiffs' attempts to get around such provisions by asserting Section 14(a) claims.[1]

This article offers a rebuttal to this trend. Section 14(a) claims should not be brought derivatively. After all, the securities laws are designed to protect investors, not to arm corporations with claims against their directors and officers.

We suggest two new arguments in defendants' arsenal to battle the wave of Section 14(a) claims brought derivatively.

First, Section 14(a) claims cannot be brought derivatively in the first place because the internal affairs doctrine requires derivative claims be brought under state corporate law.

Second, plaintiffs must establish scienter for Section 14(a) claims where the corporation has adopted an exculpatory provision pursuant to Section 102(b)(7) of the Delaware General Corporation Law.

The Internal Affairs Doctrine Should Bar Section 14(a) Claims

The rise in derivative Section 14(a) claims has frustrated recent attempts by corporations to consolidate shareholder derivative actions in a single forum and avoid the inefficiencies of multi-forum litigation on the same issues.

Delaware corporations increasingly have adopted charter provisions designating the Delaware Court of Chancery as the exclusive forum for bringing shareholder derivative actions. But some courts have not enforced these provisions against Section 14(a) claims, on the ground that only federal courts have jurisdiction over these claims.[2]

Accordingly, defendants may be subject to duplicative litigation challenging the same alleged misconduct: federal court actions asserting Section 14(a) claims and Delaware Chancery actions asserting breach of fiduciary duty claims.

This does not have to be the case. Defendants should argue that the internal affairs doctrine bars derivative Section 14(a) claims, and therefore these claims pose no barrier to enforcing exclusive forum provisions.

Derivative actions fundamentally relate to the internal affairs of a corporation, which the Delaware Supreme Court described in its 2005 VantagePoint Venture Partners 1996 v. Examen Inc. decision as "matters that pertain to the relationships among or between the corporation and its officers, directors, and shareholders."[3]

And, as the court further explained in that decision, under the internal affairs doctrine, "only the law of the state of incorporation governs and determines issues relating to a corporation's internal affairs."[4]

Thus, only Delaware state law claims should be permitted in a derivative action against the directors and officers of a Delaware corporation, unless — as the U.S. Supreme Court held in the 1977 decision in Santa Fe Industries Inc. v. Green — there is a clear indication of congressional intent to provide a remedy under the federal securities laws.[5]

Derivative Section 14(a) claims should not be permitted because there is no clear indication of congressional intent to provide corporations with this cause of action.

The Supreme Court's 1976 decision in TSC Industries Inc. v. Northway Inc. stated that the purpose of Section 14(a) is "to promote the free exercise of the voting rights of stockholders."[6] And the Supreme Court's 1964 decision in J. I. Case Co. v. Borak held there was an implied private right of action under Section 14(a) to advance this purpose.[7]

But this purpose is not implicated by derivative actions. The real party in interest in derivative actions is the corporation, not its stockholders, and the corporation does not vote on matters set forth in its proxy materials.

Because derivative suits by corporations do not implicate the core purpose of Section 14(a), there is no clear indication that Congress intended to intrude on the internal affairs of corporations by providing a derivative cause of action under Section 14(a) — especially where Delaware law already provides a derivative cause of action against fiduciaries who make misleading disclosures.

Thus, under the Supreme Court's ruling in Santa Fe, derivative claims challenging allegedly misleading proxies should be decided under Delaware breach of fiduciary duty law, not Section 14(a).

Plaintiffs will no doubt say that this argument is foreclosed by the Supreme Court's decision in Borak, which held that Section 14(a) claims could be asserted derivatively.[8] But there are several reasons why courts should not permit derivative Section 14(a) claims notwithstanding Borak.

First, the Supreme Court has repeatedly criticized Borak in the decades since it was decided. Borak's holding was based on a broad understanding of implied private rights of action that the Supreme Court has since abandoned.[9] Indeed, in the 2019 oral argument in Emulex Corp. v. Varjabedian, Chief Justice John Roberts called Borak a mistake.[10]

Second, because a private right of action under Section 14(a) is not expressly permitted under the statute and is only implied, it must be construed narrowly.[11] And since the core purpose of Section 14(a) is not implicated by derivative actions, a narrow construction of the implied right of action should foreclose derivative Section 14(a) claims.

Third, Borak's rationale for holding that Section 14(a) claims may be brought derivatively is flawed. The Borak court reasoned that derivative Section 14(a) claims were necessary because:

> The injury which a stockholder suffers from corporate action pursuant to a deceptive proxy solicitation ordinarily flows from the damage done the corporation, rather than from the damage inflicted directly upon the stockholder.[12]

But that is not the case today. Stockholders often sue companies, directors and officers directly for damages under Section 14(a), like when stockholders in an acquired company claim that a misleading proxy caused them to accept merger consideration that was less than the true value of their shares.

The flawed premise in Borak further counsels in favor of narrowly construing the private right of action to only permit actions by stockholders directly for violation of their franchise rights.

Exculpatory Provisions Impose Heightened Pleading Requirements

The second argument defendants should consider making when facing derivative Section 14(a) claims is rooted in exculpatory provisions adopted by corporations pursuant to Section 102(b)(7) of the Delaware General Corporation Law.

These provisions exculpate directors from monetary liability for breaches of fiduciary duty, except for breaches of the duty of loyalty or that involve bad faith.

Exculpatory provisions subject derivative plaintiffs to a difficult burden of pleading particularized facts that directors acted with knowledge that their conduct was illegal — a high bar that most derivative plaintiffs cannot clear.

Plaintiffs attempt to get around this pleading hurdle by asserting negligence-based Section 14(a) claims on the theory that Section 102(b)(7) exculpatory provisions do not apply to these claims. Defendants should challenge this theory.

While the applicability of Section 102(b)(7) provisions to Section 14(a) claims has not been litigated often, there are several recent decisions that have applied these provisions to Section 14(a) claims and

required plaintiffs to make a showing of bad faith.[13] Although these decisions do not offer detailed explanation, their holdings make sense.

While Section 102(b)(7) technically only applies to claims for breach of fiduciary duty, the conduct being challenged by derivative Section 14(a) claims — directors making misleading disclosures — is a breach of fiduciary duty. Plaintiffs should not be able to get around exculpatory provisions by slapping a Section 14(a) label on a claim that should have been brought as a fiduciary duty claim.

Indeed, Delaware courts have applied exculpatory provisions to causes of action that technically are distinct from fiduciary duty claims but still implicate fiduciary duties.[14] Section 14(a) derivative claims are no different, and likewise should be covered by exculpatory provisions.

Plaintiffs increasingly are bringing Section 14(a) claims in derivative suits because they perceive these claims have advantages compared to traditional fiduciary duty claims. But, as this article argues, there are several reasons why plaintiffs are wrong and the flawed assumptions underlying these claims should be tested in court.

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[1] See Seafarers Pension Plan on behalf of Boeing Co. v. Bradway, 23 F.4th 714 (7th Cir. 2022); Lee v. Fisher, --- F.4th ----, 2022 WL 1511322 (9th Cir. May 13, 2022).

[2] There is an active debate in the courts about whether exclusive forum provisions may be enforced against federal securities claims. Compare Lee v. Fisher, --- F.4th ----, 2022 WL 1511322 (9th Cir. May 13, 2022) (dismissing Section 14(a) claim pursuant to exclusive forum provision), with Seafarers Pension Plan on behalf of Boeing Co. v. Bradway, 23 F.4th 714 (7th Cir. 2022) (refusing to dismiss Section 14(a) claim pursuant to exclusive forum provision).

[3] VantagePoint Venture Partners 1996 v. Examen, Inc., 871 A.2d 1108, 1113 (Del. 2005).

[4] Id.

[5] See Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 479 (1977) (refusing to expand scope of Section 10(b) of the Exchange Act to regulate internal affairs of corporation).

[6] TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 444 (1976).

[7] See J. I. Case Co. v. Borak, 377 U.S. 426, 431-433 (1964).

[8] See Borak, 377 U.S at 431.

[9] Alexander v. Sandoval, 532 U.S. 275, 287 (2001).

[10] Emulex Corp. v. Varjabedian, No. 18-459, Apr. 15, 2019 Hr'g Tr. at 41.

[11] See Janus Cap. Grp., Inc. v. First Derivative Traders, 564 U.S. 135, 142 (2011) ("we must give 'narrow dimensions ... to a right of action Congress did not authorize when it first enacted the statute and did not expand when it revisited the law.'").

[12] Borak, 377 U.S at 432.

[13] See In re Wells Fargo & Co. S'holder Derivative Litig., 2022 WL 345066, at *5 (N.D. Cal. Feb. 4, 2022); Pickett v. Gorevic, 2021 WL 4927061, at *26 (S.D.N.Y. Mar. 26, 2021); City of Detroit Police & Fire Ret. Sys. v. Hamrock, 2021 WL 877720, at *5 (D. Del. Mar. 9, 2021); Smith v. Carrillo, 2019 WL 6328033, at *8 (D. Del. Nov. 26, 2019).

[14] See, e.g., Avande Inc. v. Evans, 2019 WL 3800168, at *9 (Del. Ch. Aug. 13, 2019) ("Waste has been viewed as being covered by an exculpation provision.").