Professional Perspective

Trends in Shareholder Derivative Litigation

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Bloomberg Law

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This article highlights two shareholder derivative litigation trends that are expected to continue in the coming year. Through both avenues, shareholder plaintiffs purporting to act in a derivative capacity will likely continue to aggressively pursue derivative litigation by expanding both their use of pre-suit discovery demands and the type of board-level conduct for which they seek to recover on behalf of the company.

First, in light of the Delaware Supreme Court's recent guidance on the defenses available to a company that has received a company books and records inspection demand by a shareholder plaintiff, we anticipate that such pre-suit discovery demands will continue—and may be more successful. Second, 2020 saw a continued upswing in shareholder derivative litigation targeting companies' actions in light of their environmental, social, and governance (ESG) disclosures—a trend we anticipate is particularly likely to continue given the Biden administration's increased focus in this arena.

Delaware Corporations, Books and Records, and Pre-Suit Discovery

Recent Delaware cases have given attorneys for shareholders expanded artillery in their efforts to obtain pre-suit discovery. Shareholders of a Delaware corporation have long had the right to demand inspection of corporate books and records and to take discovery upon a showing of a proper purpose under Section 220 of the Delaware General Corporation Law, 8 Del. C. § 220 (Section 220). To no surprise, companies have frequently resisted or attempted to limit this type of pre-suit discovery, which in essence allows plaintiffs to explore the factual basis of claims before filing a derivative suit.

But, in December 2020, in *AmerisourceBergen Corp. v. Lebanon County Employees' Retirement Fund*, the Delaware Supreme Court rejected two defenses frequently asserted by companies that seek to resist Section 220 inspection demands, holding that a shareholder need not specify the "ultimate objectives" of the investigation in the Section 220 demand or establish that the alleged corporate wrongdoing would be judicially "actionable" in order to obtain corporate records.

Instead, the shareholder need only establish a credible basis—the lowest possible burden of proof—from which a court can infer possible wrongdoing. Notably, credible allegations of corporate wrongdoing standing alone constitute a "proper purpose" under Section 220 so long as the shareholder's sole objective is not to pursue litigation. Unquestionably, shareholder plaintiffs will use this guidance to support inspection demands that will be more challenging for a company to limit, much less resist in their entirety.

Companies can likewise anticipate that these Section 220 inspection demands will be increasingly aggressive in scope. Although Section 220 limits access to books and records that are "essential" for the plaintiff to accomplish its proper investigation, in recent years, Delaware courts have reinforced that books and records are not limited to physical documents: in assessing what other categories of documents are subject to production under Section 220, what matters is whether the record is essential and sufficient to satisfy the shareholder's proper purpose, not its source. For example, in *Amalgamated Bank v. Yahoo! Inc.*, the Court of Chancery permitted inspection of materials beyond board-level materials and included corporate records and emails relating to performance of senior executives.

Likewise, in *Kt4 Partners LLC v. Palantir Technologies Inc.*, the Delaware Supreme Court reversed the Court of Chancery's decision to deny inspection of emails, noting that, if a company observes traditional formalities, such as documenting its actions through board minutes, resolutions, and official letters, it will likely be able to satisfy a Section 220 demand by producing only those books and records.

But if a company conducts formal corporate business largely through informal electronic communications, the Delaware Supreme Court held that the company cannot use its own choice of medium to keep shareholders in the dark about the substantive information to which Section 220 entitles them. And notably, in *AmerisourceBergen*, the Delaware Supreme Court affirmed the Court of Chancery's *sua sponte* granting of a corporate representative deposition to explore the types of books and records that existed given the company's refusal to disclose them.

In sum, curtailed defenses to Section 220 inspection demands coupled with a broader set of potentially available materials pre-suit will likely incentivize putative shareholder derivative plaintiffs to continue to issue aggressive Section 220 demands that provide them with pre-suit discovery. It has become more challenging, although not impossible, for companies to resist or narrow those demands.

ESG Disclosure-Based Shareholder Derivative Litigation

Not only is the continued use of Section 220 inspection demands to obtain expanded pre-suit discovery likely, but we also anticipate that putative shareholder plaintiffs will continue to attempt to expand the scope of alleged corporate wrongdoing that is subject to derivative litigation. Specifically, in 2020 we observed the continued upward trend of ESG disclosure-related derivative litigation.

An early exemplar of this trend began with derivative litigation in the wake of the #MeToo movement in 2017 and 2018. Over the last several years, courts have seen a dramatic upswing in the number of shareholder derivative suits brought against public companies' executives and directors based upon their response, or lack thereof, to complaints or allegations of sexual harassment. Some of these suits have achieved substantial recoveries.

In fall 2020, Alphabet Inc. settled a shareholder derivative action relating to the company's alleged mishandling of sexual harassment allegations against senior executives and the company's alleged overall culture of sexual discrimination and harassment. As part of that settlement, in which Alphabet established a $310 million diversity, equity, and inclusion fund, the company also committed to instituting policy reform and corporate governance reform, including ending mandatory arbitration in harassment and discrimination disputes across all Alphabet entities and establishment of an advisory council.

In 2020, the Black Lives Matter movement and related societal attention to racial justice issues appear to have had a similar substantial impact on shareholder activism through derivative litigation. Even companies that claim to be committed to diversity, equity, and inclusion, and to supporting social and racial justice, may find themselves at increased risk in this arena.

Since summer 2020 alone, shareholders have filed eight derivative suits alleging the board of directors breached its fiduciary duties when a company publicly emphasized the importance of and its dedication to diversity and inclusion yet maintained a lack of diversity on its board of directors and in high-level executive positions.

Whether plaintiffs will succeed in these derivative claims remains an open question. Indeed, on March 19, 2021, the U.S. District Court for the Northern District of California dismissed the Facebook complaint without prejudice, in part because the court found the aspirational assertions in Facebook's proxy statement not actionable. But even if the fate of these types of lawsuits is uncertain, they are likely to keep ESG disclosures and related company practices and board actions in the spotlight.

Moreover, the Biden administration's sharpened focus on ESG disclosures and issues may provide kindling for more of this type of litigation. In May 2020, the SEC's Investor Advisory Committee approved a recommendation for an integrated disclosure regime for ESG disclosures that would provide a uniform framework for related disclosures for public companies and allow investors to compare one company to another.

To what extent the framework is adopted and affects social policy governance by companies remains to be seen, but undoubtedly activist shareholders may seek to use any enhanced disclosures, data, and accountability to pursue derivative litigation.