In the Name of the Company: When Stockholders Interfere in the Boardroom

by Jenness E. Parker and Elisa M. Klein

Takeaways

- **Corporations can face a wave of stockholder actions purporting to enforce the corporations' own legal rights, from books and records requests to derivative suits and litigation demands.**
- **In contrast to class actions, there are few established procedures for resolving these disputes in a centralized forum, so companies often find themselves responding to many similar demands and suits, sometimes in multiple jurisdictions.**
- **Stockholder actions can be both expensive and distracting for companies to address, even though they are intended to benefit the company.**
- **Companies can impose some order by requiring all derivative suits to be filed in one jurisdiction and by responding uniformly to all books and records demands.**

It is a cardinal precept of corporate law that directors, not stockholders, manage the business and affairs of the corporation. Indeed, under the business judgment rule, a cornerstone of Delaware law, an independent and disinterested board cannot be second-guessed legally by courts or stockholders. That's true even when a corporation has purportedly been harmed. The board retains the authority to decide how to respond, including whether the corporation should file suit against those — including its own officers and directors — who may have harmed it.

But Delaware law provides checks on management and the board that allow stockholders to insert themselves into the management process. They can request access to corporate books and records; they can demand that the board pursue litigation against its officers and directors; and they can bring derivative suits to press claims on behalf of the company against its officers and directors that the corporation has not yet pursued.

Companies frequently find themselves looking on as stockholders sharp-elbow each other to gain control of the corporation's litigation or race to be the first to seek corporate gover-

nance reforms. Sometimes companies will receive more than a dozen stockholder books and records demands, as well as multiple litigation demands and derivative suits, simultaneously, as well as securities class action lawsuits — all arising out of essentially the same underlying facts and claims.

As a director, this issue is likely frustrating and puzzling because significant company funds and resources are required to address these stockholder actions, even though the claims ac tually belong to the company and boards are typically well-equipped to handle them without stockholder input.

We describe below the legal framework that provides grounds for these stockholders actions, and some ways boards can attempt to achieve order to protect the real party in interest: the corporation.

An Overview of Stockholder Action

When negative events — *e.g*, disappointing earnings, a government investigation, a regulatory setback or allegations of internal malfeasance — cause a company's stock to fall, litigation often follows, and often a lot of it, in multiple forums, by multiple players and in multiple forms.

Class actions. In the wake of such news, stockholders often sue the company to address *their own direct losses*, typically claiming that the company concealed information or misled them. These are the stockholders' own claims and are almost always cast as class actions on behalf of all similarly situated stockholders.

This litigation can create major financial exposure for companies, but all related cases are generally consolidated in a single court where lead counsel is appointed for the putative class, so companies are unlikely to face splintered litigation in different courts. Moreover, federal statutory reforms enacted by Congress in 1995 and subsequent case law have circumscribed some of the more egregious litigation that was routine previously. Importantly, and in contrast to the litigation described below, discovery in federal class actions is now typically stayed pending disposition of initial motions by the defendants.

Derivative suits. Ironically, companies face an entirely different scenario in derivative litigation, when stockholders take action *on behalf of the company*. Few mechanisms exists to require consolidation or coordination among these stockholders, even though they all purport to be pursuing the interests of a single party, the company.

In a derivative suit, a stockholder aims to take control of the company's own legal claims. In practice, the core allegations in these suits typically parallel class actions filed by other stockholders. For example, a derivative suit might claim that mismanagement led to litigation that has cost the company money to resolve. In the derivative action, a stockholder will seek to recoup those costs from the alleged wrongdoers — typically, officers or directors of the company — for the benefit of the company.

There are no limits on the number of stockholders who can pursue derivative claims related to the same issue. Although derivative actions filed in the same forum may be consolidated, financial incentives may compel stockholders to deliberately file in separate forums in the hope of retaining control and seeking compensation for allegedly conferring a benefit on the company.

Books and records demands. Stockholders who can satisfy the statutory requirements may also demand access to corporate books and records to support derivative suits that they intend to file. Delaware courts have long recognized that pre-suit investigation is a proper purpose for demanding books and records. In recent years, they have narrowed corporations' defenses to these requests and, as a result, companies are often swamped with books and records demands. See our October 7, 2021, Informed Board article, "This Isn't Your Grandparents' Books and Records Demand."

There is no limit on the number of stockholders who can seek books and records related to the same issues. Nor are stockholders required to seek the documents before pursuing derivative litigation. So companies already defending derivative claims by one or more stockholders may be required to respond to multiple nearly identical books and records requests from other stockholders at the same time. Stockholders who obtain books and records can use those to support their own derivative suits, potentially giving them a leg up on any stockholder that filed a derivative claim without non-public information.

It remains to be seen whether the Delaware courts will at some point pull the pendulum back in the other direction after seeing how books and records demands have come to replace, at least partially, the discovery process in class action and derivative litigation, without attendant procedural protections. But, so far, the courts have expanded, not retracted, these access rights.

Litigation demands. Still other stockholders will demand that the board itself initiate litigation against the officers or directors who allegedly harmed the company. Although sending a litigation demand is a tacit concession that the board is disinterested and independent, and

therefore can decide for itself whether to bring litigation against the alleged wrongdoers, these stockholders may still file litigation if the board chooses not to initiate litigation, arguing that the refusal was wrongful. The substance of these "demand refused" cases is typically the same as other derivative suits, but, because the initial procedural issues are distinct, they almost always proceed on a different track from other derivative litigation.

There is no limit to the number of stockholders who can lodge litigation demands related to the same issues.

Overuse of Stockholder Actions Harms the Corporation

The intense posturing for control among stockholders all trying to supplant the board can be both expensive and distracting. The corporation is the one footing the bill, including advancing litigation expenses for its officers and directors implicated in derivative suits. So the stockholders are causing the very thing they seek to redress — monetary damages purportedly caused by fiduciaries — where it is unlikely that the company will be reimbursed for any expenses it advanced. Worse still is the fact that this can, and often does, happen to corporations that are managed by fully disinterested and independent boards that do not need stockholder protection.

Derivative litigation and litigation demands are supposed to afford stockholders limited ability to pursue claims belonging to the company only when the board is disqualified from exercising its authority because of a disabling interest. Likewise, books and records requests in the litigation context are intended, in part, to help determine whether corporate governance may have failed. Unfortunately, stockholders can and do interfere even where directors have no conflicts of interest and the board has conducted its own investigation and appropriately addressed the issue.

What Companies Can Do

There is no existing statutory or judicial mechanism to impose order on suits and demands by stockholders pursuing the company's rights. However, there are some ways that companies can assert a modicum of control:

- Companies can adopt and enforce bylaws requiring all derivative suits to be filed in one jurisdiction (*e.g.*, the Delaware Court of Chancery for Delaware-incorporated companies). That increases the chances that parallel suits will be consolidated or coordinated in some way.

- **Similarly, companies can coordinate any stockholder claims arising from a board's refusal to agree to litigation demands.**
- **To promote efficiency, the corporation can disclose the identity of stockholders seeking books and records, offer the same documents to each and condition production on an agreement that any litigation over the demand take place in the same court, on the same schedule and in a coordinated manner.**
- **Companies may request that derivative actions be stayed until the resolution of any underlying class actions growing out of the same events.**

Until there is a statutory or judicial fix, these steps may create some order for corporations facing duplicative stockholder actions and may curb the expense and distraction that come with them.

Jenness E. Parker is a Partner and Elisa M. Klein is an Associate at Skadden Arps.

This entry was posted in Compliance, Corporate Civil Liability and Enforcement, Data Privacy and tagged Elisa M. Klein, Jenness E. Parker on June 10, 2022 [https://wp.nyu.edu/compliance_enforcement/2022/06/10/in-the-name-of-the-company-when-stockholders-interfere-in-the-boardroom/] by Julie Copeland.