

Shareholder Derivative Litigation: Demands from Parties Whose Shareholder Status is Uncertain

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This Article examines the current state of the law with respect to a board of directors' obligations when the shareholder status of a demanding party is unknown at the demand stage prior to shareholder derivative litigation, and provides recommendations to boards faced with this situation.

When a shareholder makes a pre-suit demand on a board of directors, the directors have a fiduciary obligation to act reasonably and in good faith when considering and responding to the demand. If the directors refuse the demand without having satisfied their fiduciary obligations, the result may be a denial of the company's motion to dismiss in ensuing derivative litigation on the ground that the demand was wrongfully refused (see *Practice Note, Shareholder Derivative Litigation: Pre-suit Demand on the Board* (<http://us.practicallaw.com/8-508-8277>)). This risk is limited to situations in which the derivative plaintiff both owns the company's stock at the time of the demand and has owned it continuously since the time of the alleged wrongdoing, as those are requirements in Delaware and other jurisdictions for standing to bring a derivative suit (see *Practice Note, Shareholder Derivative Litigation: Plaintiff Must Have Standing to Sue* (<http://us.practicallaw.com/8-508-8277>)).

Because losing a motion to dismiss for wrongful refusal may lead to long and costly discovery on the merits, it is essential that the board treat every pre-suit demand properly. The board faces a thorny issue, however, when the demanding party refuses to provide sufficient evidence of its shareholder status at the demand stage. The board must then decide whether to expend time and resources investigating allegations made by someone who might lack standing to later assert a derivative claim.

Conflicting opinions among various state and federal courts on the issue make this determination difficult. While some courts have issued opinions indicating that evidence of shareholder status is not

necessary at the demand stage, a growing number of courts require that a demanding party reasonably demonstrate its shareholder status before imposing any obligation on the board to act on a demand. Because of this uncertainty, it is important for a board of directors to understand:

- The cases in which courts have held that a board must consider a demand, regardless of whether the demanding party has presented proof of its shareholder status at the demand stage (see *Proof of Stock Ownership Not Required*).
- The cases in which other courts have held that a board is not obligated to act on a demand unless the demanding party has reasonably demonstrated its shareholder status at the demand stage (see *Proof of Stock Ownership Required*).
- The steps a board should take when presented with a pre-suit demand in light of conflicting legal authority (see *Recommendations to the Board*).

PROOF OF STOCK OWNERSHIP NOT REQUIRED

Even in Delaware, considered a model jurisdiction for its well-defined standing requirements for derivative litigation (see *Del. Code Ann. tit. 8, § 327*), there is no law directly on point regarding whether a demanding party must present any proof of shareholder status at the pre-suit demand stage. The Delaware Code is silent on this issue, and no Delaware court has ruled on this precise issue.

Several courts have issued opinions that may indicate that demanding parties are not required to produce information about their shareholder status at the pre-suit demand stage, including:

- The Delaware Court of Chancery in its *Schick Inc. v. Amalgamated Clothing & Textile Workers Union* opinion (see *Schick Inc. v. Amalgamated Clothing & Textile Workers Union*).
- The US District Court for the Southern District of New York in its *Kautz v. Sugarman* opinion (see *Kautz v. Sugarman*).
- The US District Court for the District of Minnesota in its *Iron Workers Mid-South Pension Fund v. Davis* opinion (see *Iron Workers Mid-South Pension Fund v. Davis*).



SCHICK INC. V. AMALGAMATED CLOTHING & TEXTILE WORKERS UNION

Shareholder derivative plaintiffs often point to the 1987 *Schick Inc. v. Amalgamated Clothing & Textile Workers Union* decision as support for the argument that a board must consider a demand regardless of who makes it (533 A.2d 1235 (Del. Ch. 1987)). In *Schick*, a company sought a declaration that it was not obligated to consider a demand made by a union that had acquired company stock only after its collective bargaining negotiations with the company broke down. While conceding that the union was a current shareholder, the company contended that it was entitled to refuse the demand because the union's sole purpose in making the demand was to harass the board following failed collective bargaining negotiations. The union's alleged harassment also included work stoppages and slow downs, sabotage and picketing the company's lending institutions. (*Schick Inc.*, 533 A.2d at 1236-37.)

The court declined to make the declaration, explaining that a demand "is really a form of notice designed to afford to the corporation's board an opportunity to consider the facts asserted and to exercise its business judgment whether to press any arguable claim the corporation may possess or to take other action" (*Schick Inc.*, 533 A.2d at 1240). Although recognizing that the board "has no obligation to take any specific type of action to comply with a demand," the court explained that, because a demand "serves a notice function, it makes little difference with respect to the board's duty, upon receiving information ... whether the information comes from a stockholder or from another and thus it makes little sense to think in terms of 'entitlement to make a demand'" (*Schick Inc.*, 533 A.2d at 1240). Therefore, the board's duties "would not be materially different by reason solely of the fact that the information comes from a stockholder, a supplier or customer or even a busybody" (*Schick Inc.*, 533 A.2d at 1241).

The interpretation offered by derivative plaintiffs is that *Schick* stands broadly for the proposition that a board's:

- Duty to consider and respond to a demand does not turn on the source of the demand, including one from a non-shareholder.
- Refusal to consider a demand, regardless of its source, is wrongful.

Such a broad interpretation is not warranted, and no court has read *Schick* so expansively. The *Schick* opinion did not answer the question of whether a board **acts wrongfully** if it declines to consider a demand made by a person whose shareholder status has not been verified. Instead, the issue the Delaware Court of Chancery considered was whether boards can refuse demands allegedly made solely to harass. Critically, there was never any doubt that the demanding party in *Schick* was a shareholder who had standing to sue derivatively. (*Schick*, 533 A.2d at 1236-37.)

KAUTZ V. SUGARMAN

In *Kautz v. Sugarman*, the board of directors of a Maryland corporation requested confirmation of the demanding party's stock ownership before agreeing to commence any investigation into the assertions made in the demand (Nos. 10 Civ. 3478(RJS), 10 Civ. 4312(RJS), 2011 WL 1330676 (S.D.N.Y. Mar. 31, 2011)). The board requested, among other things, statements indicating when the demanding

party initially purchased the stock and whether the demanding party owned the stock at the time of the demand. (*Kautz*, 2011 WL 1330676, at *1.) After the demanding party refused to provide the requested documentation, counsel for the board stated that the two sides were therefore at an "impasse" (*Kautz*, 2011 WL 1330676, at *1-2).

The demanding party filed a derivative complaint claiming wrongful refusal of her demand (*Kautz*, 2011 WL 1330676, at *2). The plaintiff also then produced, for the first time, an affidavit stating that she purchased the company's stock prior to the alleged misconduct and that she continued to own the shares to the present (*Kautz*, 2011 WL 1330676, at *3-4).

Applying Maryland law, which the court likened to Delaware law, the court denied the defendants' motion to dismiss, explaining that there is no "bright-line rule" requiring parties making demands on boards to prove their standing at the time of the demand (*Kautz*, 2011 WL 1330676, at *6). The court held that the plaintiff's affidavit verifying her current stock ownership, provided only after filing of the derivative complaint, was sufficient to show standing. Therefore, despite the fact that the plaintiff provided no evidence of current shareholder status at the time of the demand, the court rejected the argument that she had failed to make an adequate pre-suit demand. Moreover, instead of permitting the board to proceed with its consideration of the demand, the court ordered discovery on the deliberations that led to the board's decision not to act on the plaintiff's demand prior to receiving more information about the plaintiff's stock ownership. (*Kautz*, 2011 WL 1330676, at *3-6.)

The *Kautz* decision provides an example of a successful "hide-the-ball" litigation strategy used by some derivative plaintiffs to attempt to circumvent the substantial deference that courts have accorded board-level decisions to reject pre-suit demands. Such a strategy includes:

- Concealing shareholder status from the company at the demand stage.
- Hoping the board refuses to investigate the demand absent the provision of additional information.
- Producing evidence of shareholder status only after filing a derivative suit claiming wrongful refusal.

The *Kautz* case highlights the risks a board may face if it chooses to refuse a demand based solely on the demanding party's failure to provide sufficient evidence of stock ownership. Those risks include:

- Denial of a motion to dismiss on the provision of evidence of shareholder status after the filing of the derivative action.
- Discovery that could have been avoided had the board considered the demand and rejected it on its merits.

IRON WORKERS MID-SOUTH PENSION FUND V. DAVIS

In *Iron Workers Mid-South Pension Fund v. Davis*, the US District Court for the District of Minnesota denied the defendants' motion to dismiss the plaintiff's derivative complaint because of the board's lack of due diligence in investigating the plaintiff's shareholder status at the demand stage (No. 13-289 (JRT/JJG), 2013 WL 6858567, at *6 (D. Minn. Dec. 30, 2013)). In this case, the demanding party asserted in its de-

mand that it was a shareholder and, upon request, provided evidence that it owned company stock. However, that evidence showed stock ownership several months after the demand rather than at the time of the demand. The board then requested proof of the duration of the demanding party's stock ownership, but did not explain that it was unable to ascertain the demanding party's shareholder status on its own. The demanding party filed suit shortly thereafter. (*Iron Workers*, 2013 WL 6858567, at *4-*6.)

Emphasizing that there was no evidence in the record showing that the board had made any effort to determine the plaintiff's shareholder status from its own books and records, the court held that the demand was wrongfully refused because the board's lack of due diligence raised a reasonable doubt as to whether the board was acting in good faith and with due care in responding to the demand (*Iron Workers*, 2013 WL 6858567, at *6).

PROOF OF STOCK OWNERSHIP REQUIRED

An emerging trend in the US district courts is to require the demanding party to reasonably demonstrate its shareholder status at the time of the demand. The precise contours of this requirement are still undefined, however. The leading decisions on this issue include:

- The US District Court for the Eastern District of Pennsylvania in its *Richelson v. Yost* opinion (see *Richelson v. Yost*).
- The US District Court for the Southern District of New York in its *Shenk v. Karmazin* opinion, reached despite that court's prior ruling in the *Kautz* case (see *Shenk v. Karmazin*).
- The US District Court for the Northern District of California in its *Wang v. Page* opinion (see *Wang v. Page*).

RICHELSON V. YOST

The US District Court for the Eastern District of Pennsylvania's opinion in *Richelson v. Yost* is the foundational case establishing the obligation of a demanding party to reasonably demonstrate its shareholder status at the demand stage (738 F. Supp. 2d 589 (E.D. Pa. 2010)). In *Richelson*, the company checked its books and records after receiving a demand, but was unable to confirm whether the demanding party was a shareholder. The company then requested confirmation of the demanding party's shareholder status, including information such as:

- The account or nominee through which the demanding party held shares.
- The number of shares owned by the demanding party.
- The date the demanding party first became a shareholder.
- Whether the demanding party had been a continuous owner since the date the party first became a shareholder and whether there were any changes in the level of ownership during that time.

(*Richelson*, 738 F. Supp. 2d at 594.)

The demanding party did not respond to the company's requests, and instead filed a derivative suit based on a theory of wrongful refusal. In the complaint, the plaintiff alleged that he was a current shareholder of the company, and had owned stock continuously since the time of the alleged wrongdoing. (*Richelson*, 738 F. Supp. 2d at 595.)

Applying Delaware law, and noting that there was scant legal authority addressing this issue, the court dismissed the complaint for lack of standing, holding that a board has no obligation to respond to a demand from an alleged shareholder whose standing cannot be confirmed at the demand stage (*Richelson*, 738 F. Supp. 2d at 598). Although noting that Delaware law does not explicitly impose an obligation for a demanding party to prove that it is a shareholder when making a pre-suit demand, the court explained that Delaware's derivative litigation standing requirements (see *Del. Code Ann. tit. 8, § 327*) reflect that a board does not need to act on a demand letter if, after a reasonable, good-faith investigation, it cannot confirm the demanding party's shareholder status (*Richelson*, 738 F. Supp. 2d at 599). When a board is unable to ascertain whether a demand letter is from an actual shareholder through the exercise of reasonable due diligence, the board may either request additional information from the demanding party, as in *Richelson*, or "discard the letter entirely" (*Richelson*, 738 F. Supp. 2d at 600).

In *Richelson*, therefore, the court dismissed the complaint, even though the complaint included allegations satisfying the contemporaneous and continuous stock ownership requirement, because the plaintiff had failed to provide the board with information reasonably demonstrating his shareholder status at the demand stage (*Richelson*, 738 F. Supp. 2d at 599-600).

SHENK V. KARMAZIN

In *Shenk v. Karmazin*, the US District Court for the Southern District of New York followed the Eastern District of Pennsylvania's *Richelson* decision and held that the demanding party "must allow the board to 'ascertain through the exercise of due diligence whether the demand ... is coming from a shareholder'" (867 F. Supp. 2d 379, 382 (S.D.N.Y. 2011)). The court thus declined to embrace the holding of *Kautz*, in which the Southern District of New York held, only seven months earlier, that there was no "bright-line rule" requiring parties making demands on boards prove their standing at the time of the demand (*Kautz*, 2011 WL 1330676, at *6).

In *Shenk*, although the demanding party provided documentation with the demand purportedly showing that he was a "continuous and contemporaneous owner" of the stock, the court concluded that the documents "failed to show that he owned stock at the time of the events of which he complained" (*Shenk*, 867 F. Supp. 2d at 382-83). Therefore, the court granted the defendants' motion to dismiss for failure to make an adequate pre-suit demand (*Shenk*, 867 F. Supp. 2d at 383).

WANG V. PAGE

In *Wang v. Page*, Google's board requested documentary evidence of the demanding party's stock ownership, but the demanding party ignored the request, instead filing a derivative suit claiming wrongful refusal (*Wang v. Page*, No. C 12-1785 PJH, 2012 WL 3278717, at *2 (N.D. Cal. Aug. 10, 2012)). In evaluating the defendants' motion to dismiss, the Northern District of California agreed with the Eastern District of Pennsylvania's view that directors should not be forced to consider demands from those who are not shareholders. Although stating that the board had requested too much by seeking "written confirmations" reflecting the demanding party's stock ownership, the court held that

the board did not wrongfully refuse the demand because the plaintiff should have provided at least some information to show the amount and dates of her holdings in the company's stock. (*Wang*, 2012 WL 3278717, at *2.)

RECOMMENDATIONS TO THE BOARD

Although the issue is not settled, a growing number of courts (with *Kautz* the lone exception) are requiring demanding parties to demonstrate at the demand stage their contemporaneous and continuous ownership of the company's stock. But given the courts' varied points of emphasis, such as the focus on the demanding party's evidence versus the corporation's diligence, coupled with the lack of specific guidance concerning the extent of the evidence required, a board may still not know what it must do to satisfy its fiduciary obligations when receiving a demand letter from a party whose shareholder status it cannot determine. Despite this lack of clarity, there are several steps a board should take when receiving a demand from a party whose status as a continuous and contemporaneous shareholder is in doubt.

When a board receives a demand, it should:

- Initially attempt to verify the demanding party's shareholder status from its own books and records. The *Iron Workers* court, in particular, held that a board's failure to perform its own due diligence could be fatal to a motion to dismiss (see *Iron Workers Mid-South Pension Fund v. Davis*).
- Request additional information from the demanding party and explain in its request that it is doing so because it was unable through its own due diligence to verify the demanding party's shareholder status. In making this request, the board should expressly state that it is not rejecting the demand by asking for more information.
- The board should make clear that it stands ready to consider the demand once the demanding party supplies the requested information about its stock ownership.

Although no court has prescribed precisely what information a board should seek from the demanding party, the decisions suggest that courts would not deem it unreasonable if a board requested at least:

- Documentary evidence of current stock ownership and ownership at the time of the demand, which might consist of a copy of a current account statement.
- Information (as opposed to documentary evidence) as to the amounts and dates of the demanding party's stock holdings over time, which would provide reasonable assurances of continuous ownership since the time of the alleged misconduct while heeding the warning of some courts not to impose an excessive evidentiary burden at the demand stage (see *Richelson*, 738 F. Supp. 2d at 600 n.10; *Wang*, 2012 WL 3278717, at *2).

If the demanding party fails to provide such additional information upon request, and the board previously attempted to find the information in its own books and records, the board should feel confident that it may properly reject the demand. If the demanding party responds with documentation that suggests that is not a current shareholder or was not a shareholder at the time of the alleged

wrongdoing, then a board should likewise be confident that any derivative suit would be dismissed by a court for lack of standing (see *Shenk v. Karmazin*).

If, however, the shareholder responds with information as to the amount and dates of its stock holdings, even if short of actual "proof," the board should take a cautious approach and consider the demand if those dates show contemporaneous and continuous ownership. Courts generally respect the business judgment of boards, and boards would be prudent not to risk losing the deference afforded to them in these circumstances in light of the unsettled state of the law.

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