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PERSPECTIVES

LITIGATION OF DERIVATIVE STANDING ISSUES IN SUITS IN UNITED STATES FEDERAL COURTS

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Shareholder derivative claims – claims belonging to a corporation which are asserted by its shareholders – are common claims in US federal courts. Typically, these claims seek redress for an alleged injury to the corporation caused by an action or decision by the corporation's directors or officers and can include claims such as breach of fiduciary duty and negligence, among other things. Standing is a threshold issue as to whether a shareholder may prosecute a derivative claim. This issue is often hotly contested, and the governing law can have a profound impact on how the court rules.

In analysing standing in derivative cases, federal courts in the US typically apply the substantive law of the country or state under which the corporation was organised. Courts in some states, like New York, reach this result pursuant to the 'internal affairs' doctrine. Under this doctrine, claims involving the rights and liabilities of a corporation – including the rights of shareholders to bring derivative claims – are governed by the jurisdiction of incorporation. Courts in other states, like New Hampshire, apply state statutes that provide that the law of the jurisdiction of incorporation governs derivative claims.

In this article, we compare how US federal courts apply domestic standing rules versus British

Commonwealth standing rules. It is easier for shareholders to establish derivative standing under American law than it is under British Commonwealth law. Thus, shareholders considering a potential derivative suit in a US federal court with respect to a corporation organised in a Commonwealth jurisdiction should try to find a path for application of American standing rules, and if that is not possible, should consult with counsel from the Commonwealth jurisdiction to try to develop a theory of derivative standing under the jurisdiction's standing rules.

In the US, derivative standing has several components: the shareholder must be an adequate representative for other shareholders, must own the corporation's stock; and importantly, must satisfy the 'demand requirement'. The demand requirement is usually the main bar to standing in the US.

In federal courts, rule 23.1 of the Federal Rules of Civil Procedure governs the pleading standards for a derivative claim. However, federal courts apply state law to assess the substance of the demand requirement.

Under Delaware law – which is the leading jurisdiction on corporate law in the US – to meet the demand requirement, a shareholder must show that the board or a committee thereof wrongfully refused to prosecute the claim after the shareholder made a demand, or a shareholder demand on the board would have been futile. The legal standards for proving a wrongful refusal by the board or a committee thereof are onerous, as the board's or committee's decision not to prosecute a claim is typically entitled to deference. Therefore, in many cases, shareholders do not make any demand. Instead, they seek to establish demand futility. Generally speaking, demand futility requires a showing that the board or committee would lack the independence or disinterestedness to properly consider a shareholder demand to prosecute a claim.

While the demand futility standard is a substantial hurdle, it is not an insurmountable barrier to standing. There are numerous decisions in federal courts holding that shareholders have adequately pled or established demand futility.

By contrast, as interpreted by federal courts in the US, British Commonwealth law limits derivative standing based on the type of harm allegedly suffered by the shareholder, or the nature of the alleged misconduct. Federal courts applying English law and the law of Commonwealth jurisdictions have held that a shareholder has standing only in four narrow circumstances: (i) if the alleged conduct harmed any of the personal rights belonging to the shareholder; (ii) if the alleged conduct would require a special majority to ratify; (iii) if the wrongdoer allegedly committed a 'fraud on the minority'; and (iv) if the alleged conduct was an *ultra vires* act.

Federal courts have asked whether the first of these circumstances is properly characterised as a derivative claim at all. In the US, generally, shareholders can pursue claims based on alleged injuries to their personal rights as shareholders directly instead of derivatively. In any event, based on our review of case law in federal courts, fraud on the minority is the theory that shareholders of British Commonwealth corporations most frequently invoke, and therefore, we focus on that theory, as it has been applied in federal courts in the US.

To rely on the fraud on the minority theory, a shareholder must establish two elements. First, the alleged wrongdoers must have had control over a majority of the corporation's shares with voting rights. Second, the alleged wrongdoers must have committed 'fraud'.

'Fraud' in this context has a different meaning than how the term is commonly understood in the

US. In particular, fraud for purposes of the fraud on the minority theory requires a showing that the wrongdoer misused his or her control for his or her own benefit and at the expense of the corporation. Thus, as federal courts have recognised, British Commonwealth law does not permit a derivative action for breach of fiduciary duty absent self-dealing by those in control. In contrast, US law does permit such derivative actions, so long as the shareholder can satisfy the wrongful refusal or demand futility standards discussed above and otherwise has standing.

In a number of cases, federal courts have rejected the fraud on the minority theory applying the law of various Commonwealth jurisdictions. For example, federal courts have held that the theory cannot be invoked in the situations outlined below.

First, where directors received stock options, but the plaintiff failed to allege that the options were not properly earned and failed to allege that the directors gained from increases to the corporation's share price at the expense of other shareholders.

Second, where directors allegedly engaged in accounting fraud, resulting in artificially inflated stock prices, which the court evidently concluded benefitted all shareholders at the time, not just the directors.

Third, where directors approved contracts allegedly granting excessive compensation to a corporation's chairman of the board and president and chief operating officer, where there was no allegation that members of the corporation's compensation committee personally benefitted.

Fourth, where the defendants allegedly purchased shares from minority shareholders at artificially low prices, but there was no allegation that the corporation itself was injured by these transactions.

Lastly, where the plaintiffs could not establish that the defendants had control over a majority of the corporation's voting shares.

In addition, federal courts have held that to invoke the fraud on the minority theory under Commonwealth law, the defendant must have

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obtained some benefit beyond the normal benefits of employment.

So rigorous are the requirements of the fraud on the minority theory, as applied by the US federal courts, that we have not found a single case in those courts permitting a plaintiff to invoke that theory.

In sum, the US and British Commonwealth jurisdictions impose significant standing requirements on derivative suits. In US federal courts, it is easier to satisfy the 'demand' requirements imposed under American law than it is to satisfy the threshold standing requirements imposed under British Commonwealth law. Thus, a shareholder considering a derivative suit in the US federal court involving a British Commonwealth corporation should try to find a way forward under which American derivative standing rules would be applied, or work with counsel in the Commonwealth jurisdiction on a theory that would satisfy the derivative standing rules of the jurisdiction. CD

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