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He Who Does Not Hesitate Is Lost When Pleading Demand Futility

By **Alexander D. Widell**

Criminal and civil enforcement proceedings against corporations show no sign of abating, and the penalties, fines and settlements associated with such proceedings can be staggering. Last month, Goldman Sachs agreed to pay the Federal Housing Finance Administration $1.2 billion to settle litigation arising out of the fraudulent sale of mortgage-backed securities. In June of this year, BNP Paribas agreed to plead guilty and pay $8.9 billion in penalties for illegally processing financial transactions for countries subject to U.S. economic sanctions. In May, Credit Suisse pleaded guilty to conspiracy to assist U.S. taxpayers in filing false income tax returns with the Internal Revenue Service, and agreed to pay a fine of $2.6 billion; and last year, Johnson & Johnson paid $2.2 billion to resolve criminal and civil charges arising out of its marketing of prescription drugs for off-label uses.

Derivative lawsuits driven by specialized shareholder law firms, aimed at a corporation's individual directors, often follow in the wake of criminal and civil enforcement proceedings and the multibillion-dollar payments to resolve those proceedings. The precipitous filing of such lawsuits, however, without a proper factual investigation of the board's knowledge and involvement in the liability-causing conduct can doom the lawsuit from the beginning and lead to an early and permanent dismissal. One important, but often overlooked and underused, pre-suit investigatory tool is a books and records demand, which provides "behind the scenes" access to a corporation's nonpublic documents.

Because directors, rather than shareholders, manage the business and affairs of the corporation, shareholders are generally not permitted to bring a lawsuit on behalf of a corporation unless they first make a demand on the board of directors to take action, and the board refuses to so act. An exception exists, however, where a pre-suit demand on the board would be futile because at least half of its members face a substantial likelihood of personal liability for participation in the underlying alleged wrongdoing. In order to establish such directorial liability in cases involving criminal or regulatory misconduct, shareholders' counsel must plead and prove that the board either intentionally caused the corporation to engage in unlawful conduct, permitted unlawful conduct to continue by failing to act in the face of "red flags," or completely abdicated their duty to be active monitors of the corporation's performance.[1]

A law firm's ability to draft a complaint that successfully pleads such conduct—and, therefore, "demand futility"—has proven difficult because the facts required to prove directorial liability are typically not contained in publicly available documents, but rather, in internal corporate documents, such as minutes of board meetings, board presentations, email communications between the board and management, and communications with regulatory agencies.

A books and records demand can provide a law firm with access to such internal documents and the information it needs to adequately plead "demand futility" and defeat a motion to dismiss. Unfortunately, because of the potential for significant legal fees that are available to derivative shareholder's counsel who control the litigation, specialized shareholder law firms often race to the courthouse to be the first to file a lawsuit immediately upon the announcement of a government investigation or payment of an astronomical penalty, yet they fail to conduct any investigation to determine whether a pre-suit demand on the board of directors is excused as futile. Two important opinions issued by the Delaware Court of Chancery illustrate the risks a shareholder takes by hurriedly filing

ALEXANDER D. WIDELL *is a partner at Moritt Hock & Hamroff in the firm's Garden City office.*

a derivative action without conducting a pre-suit investigation.

'South v. Baker'

South v. Baker, 62 A.3d 1, 16 (Del. Ch. 2012), arose out of a series of serious accidents, some fatal, that occurred at a mine owned and operated by Hecla Mining Company. In January 2012, the U.S. Mine Safety and Health Administration (MSHA) issued a press release that contained the results of its inspections of Hecla, which included 59 citations for violating safety standards. Hecla, too, issued a press release that announced that MSHA had ordered the company to close part of the mine, resulting in a lowered projection of its estimated silver production in 2012. The press releases prompted a race to the courthouse, which included two federal securities actions and seven derivative actions. All of the derivative actions sought to hold Hecla's individual directors liable for losses to the company.

In the one derivative action that was brought in Delaware, the shareholders neither sought to inspect Hecla's books and records prior to commencing the lawsuit, nor made a pre-suit demand on Hecla's board of directors to institute litigation to recover the company's losses. In granting the director-defendants' motion to dismiss the action based on plaintiffs' failure to allege that the pre-suit demand on the board was excused as futile, the court held that plaintiffs failed to allege facts supporting any of the actionable connections between the mining accidents and the board of directors.

In so doing, the court indicated where a pre-suit inspection of Hecla's books and records may have resulted in a different outcome. For example, plaintiffs did not allege any facts from which it could be inferred that the directors consciously violated a statute, regulation or other law. The court noted that instead of looking for such evidence by exercising their right to inspect the corporation's minutes and other documents from board and safety committee meetings, they chose instead to rely on publicly available documents that discussed day-to-day operational issues, rather than board-level decisions.[2]

The court also rejected plaintiffs' assertion that the board exhibited a conscious indifference in the face of red flags—i.e., the series of accidents at the mine—by continuing to ignore the safety issues at the mine. The court stated that "the complaint nowhere alleges anything that the directors were told about the incidents, what the board's response was, or even that the incidents were connected in any way." In providing guidance to future litigants, the court stated: "Here again, [plaintiffs] might have used [a books and records inspection] to investigate what the directors knew and did, evaluate their theories of liability, and make an informed decision about whether or not to sue."

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Based on plaintiffs' failure to plead particularized facts to support a reasonable inference that a majority of the board faced a substantial risk of liability, the court dismissed the complaint for failure to plead demand futility.

'Louisiana Mutual'

Another recent case, *Louisiana Municipal Police Employees' Retirement System v. Pyott*, 46 A.3d 313 (Del. Ch. 2012), tells a much different story, and well-illustrates the benefits that can be obtained by not rushing to the courthouse and, instead, conducting a pre-suit investigation of internal corporate documents. That case involved Allergan, Inc., the company that manufactures the muscle relaxant Botox.[3] On Sept. 3, 2010, Allergan pleaded guilty to claims of misbranding and off-label marketing of Botox from 2000-2005, and agreed to pay $600 million in criminal and civil fines to the U.S. Department of Justice. Two days later, the Louisiana Municipal Police Employees' Retirement System (LAMPERS) filed a derivative action in Delaware against Allergan's directors based solely on publicly available information.

Meanwhile, on Nov. 3, 2010, UFCW Local 1776 & Participating Employers Pension Fund (UFCW), another shareholder of Allergan, sent Allergan a demand to inspect its books and records. After having obtained the documents it demanded, including written strategic plans and detailed presentations made at board of directors' meetings, UFCW intervened as a plaintiff in the action and, with LAMPERS, filed a new complaint. Because neither of the plaintiffs made a pre-suit demand on Allergan's board of directors, they were required to allege that demand was excused as futile because at least half of the board faced a substantial risk of liability.

Plaintiffs sought to hold Allergan's directors responsible for the company's unlawful activity based on allegations that the board itself, and not employees deep within the organization, affirmatively and consciously set out to violate the laws against off-label marketing of pharmaceuticals. Despite the historical difficulty shareholders have had in successfully alleging facts to support such an intent-based theory of liability, plaintiffs were able to do so based on the documents they obtained pursuant to UFCW's books and records demand.

For example, UFCW obtained a slide presentation and versions of written strategic plans that were provided to the board that summarized Allergan's plan to increase sales of Botox for off-label uses. One of the slides in the presentation showed that a "top corporate priority" of Allergan was to "maximize new products." One of those products was Botox, which the presentation stated could be used to treat "spasticity, migraine and pain," uses that had not been FDA-approved and were therefore "off-label."

Another slide describing the "charter" for the Botox "business portfolio

strategy" showed a plan by Allergan to devote resources to "grow new indications and develop follow-on toxins," and again identified spasticity, back pain and headache as uses for Botox. The written strategic plans that UFCW obtained through their inspection provided further support for plaintiffs' allegations that Allergan's board affirmatively knew of and approved the company's plan for explosive growth in Botox sales through the marketing and promotion of the drug for off-label uses.

One section of a strategic plan stated that "[i]nvestments in new indications of pain and migraine headache represent two of the top three future growth opportunities in our portfolio with combined peak year sales of $1.26 billion!" Consistent with the discussions in the presentation slides, Allergan's written strategic plans contemplated that the company would enter both the migraine headache and back pain markets, and contemplated marketing plans and programs to promote such off-label use.

Allergan's internal documents provide plaintiffs facts that allowed them to allege with factual specificity that Allergan's board regularly monitored Botox sales and the revenue generated from different categories of Botox use. Reports reviewed by the board showed that between 2000 and 2004, Botox sales grew between 25 and 42 percent, even though Botox had only been approved for four uses where demand was limited. Because off-label sales of Botox for spasticity, headache and pain grew by an average of 750 percent, the court held that, at the pleading stage, it was reasonable to infer that the board knew that it was unlikely that physicians were independently supporting off-label uses in the same areas that Allergan was targeting pursuant to its strategic growth plan. Accordingly, the court denied defendants' motion to dismiss for failure to plead demand futility.

Pleading Demand Futility

A shareholder's failure to adequately plead demand futility may forever preclude the company's other shareholders from pursuing a derivative action to redress the same misconduct—even those shareholders who conduct a books and records inspection and obtain facts that allow them to adequately plead demand futility. In *Louisiana Municipal*, defendants argued in the Chancery Court that the shareholder plaintiffs should be collaterally estopped from alleging demand futility because a California federal court had earlier dismissed a derivative action brought by a different shareholder based on his failure to adequately plead demand futility.

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In rejecting defendants' collateral estoppel argument, the Chancery Court held that where a plaintiff rushes to file a lawsuit prior to conducting a factual investigation, and as a result fails to adequately plead demand futility, a presumption exists that the plaintiff is not an adequate fiduciary because he is serving the financial interests of the law firm that filed the lawsuit, rather than the best interests of the corporation. In the absence of a finding of adequacy, the shareholder's actions are not binding on the corporation's other shareholders.

The Delaware Supreme Court, however, rejected the Chancery Court's "'fast filer' irrebuttable presumption of inadequacy."[4] In so doing, the court stated that "there is no record support for the trial court's premise that stockholders who file quickly, without bringing a §220 books and records action, are a priori acting on behalf of their law firms instead of the corporation." Because there was no factual basis on which to conclude that the plaintiffs in the California derivative action were inadequate, the Supreme Court reversed the Chancery Court's judgment denying defendants' motion to dismiss on collateral estoppel grounds.

Conclusion

Derivative lawsuits are an important mechanism in a corporation's ability to recover losses stemming from directorial misconduct. However, for the device to serve its intended purpose, specialized shareholder law firms must resist the economically driven impulse to file a derivative suit immediately upon the heels of a criminal investigation or regulatory enforcement proceeding.

Because directorial liability is usually difficult to plead solely from publicly available information, shareholders and their counsel should avail themselves of their right to inspect the corporation's internal books and records. If shareholders do not conduct such an investigation and leap to litigate without first providing the board of directors with an opportunity to take action on behalf of the corporation, the director defendants will likely be able to end the lawsuit in the earliest stages because of plaintiff's inability to adequately allege demand futility. Such a race to the courthouse and resulting hastily filed lawsuit may not only have an adverse impact on the very corporation shareholder counsel is purporting to represent, but may also prevent different shareholders who do conduct a pre-suit investigation from pursuing claims arising out of the same misconduct.

1. See *In re Caremark International Inc. Deriv. Litig.*, 698 A.2d 959 (Del. 1996).
2. *South v. Baker*, Case No. 7294-VCL, 2012 WL 4372538, at **10-11 (Del. Ch. Sept. 25, 2012).
3. See *Louisiana Municipal Police Employees' Retirement System v. Pyott*, 46 A.3d 313 (Del. Ch. 2012).
4. 74 A.3d 612 (Del. 2013).