

# Pick Your Forum

Designating Delaware as your venue can help minimize the impact of derivative suits

**I**N TODAY'S POST-ENRON, SARBANES-OXLEY world, securities fraud suits increasingly plague corporations. In one type that is particularly onerous to defend—derivative suits—the plaintiff is technically the corporation itself.

Shareholders bring such suits in state court not as individuals but on behalf of the company against the board of directors or officers for alleged corporate malfeasance. Often filed alongside a federal class action, a derivative suit claims the directors breached their fiduciary duty to the company because the wrongdoing occurred on their watch.

“The shareholders are stepping into the shoes of the corporation, asserting that the corporation can’t protect its own interests,” explains Dale Barnes, cochair of the Securities Litigation Practice at Bingham McCutchen in San Francisco.

Traditionally filed to challenge proposed transactions (arguing, for instance, that a deal

*Bingham McCutchen*

## EXECUTIVE SUMMARY

Shareholder derivative suits in state court have become common companions to federal class actions for securities claims. Derivative suits can be exorbitantly expensive for corporations even if they settle—but especially if they proceed into discovery. The best way to minimize the impact of these suits is to amend corporate bylaws to include a forum-selection clause, with corporation-friendly Delaware as the forum.



was structured for the benefit of insiders), derivative suits have become a tool for repackaging corresponding federal class actions that are otherwise prohibited in state court. These cases are expensive to defend, especially if the claims make it past the pleading stage into discovery. But after Barnes defended one particularly costly derivative suit, he thought of a way for companies to curb the impact of these lawsuits.

### GETTING INTO STATE COURT

In class action securities litigation, shareholders seek recovery of personal investment losses allegedly caused by corporate wrongdoing, and any monetary recovery is divided among the shareholder-plaintiffs. Derivative suits are similarly brought by shareholders, but because the plaintiff is actually the corporation itself, any monetary relief goes to the

## EXPERT ADVICE

### AMENDING BYLAWS

While forum-selection clauses are not typically included in corporate bylaws, nothing indicates they can't be. Most Delaware corporations' bylaws permit amendment by board resolution, says Bingham McCutchen partner Dale Barnes, and it is inexpensive to have counsel draft a resolution of amendment for consideration at the next board meeting.

Delaware courts scrutinize amendments to bylaws under a reasonableness test, and forum-selection clauses are presumptively reasonable. Choosing Delaware as the forum is especially reasonable for a Delaware corporation because it is already governed by Delaware law under the internal affairs doctrine, a long-standing choice-of-law principle recognizing that the state of incorporation alone should have the authority to regulate a corporation's internal affairs.

corporation's coffers—not to shareholders.

The Private Securities Litigation Reform Act of 1995 (PSLRA) instituted procedural barriers to federal securities law class actions. Specifically, before the PSLRA, plaintiffs filing federal court claims could generally allege "scienter"—that is, a deliberate intent to do wrong. But the PSLRA required plaintiffs to allege scienter with particularity, a much stricter standard. So plaintiffs began filing securities law claims in state courts, which typically have lower pleading standards and judges who may have less experience in securities law.

In response, in 1998 Congress passed the Securities Litigation Uniform Standards Act, which provided, essentially, that if it smells like a federal securities law action, it must be filed in federal court or it will be removed to federal court. But a specific exemption was made for shareholder derivative claims, which could continue in state court. As a result, derivative claims gained popularity; they typically contain allegations identical to a federal complaint but, as state court claims, are not governed by the PSLRA's pleading standards.

According to Barnes, plaintiffs counsel have increasingly used derivative actions as a vehicle for bringing claims against corporate directors and officers. They have also used them to keep claims in court past motions to dismiss and into discovery. "The company ends up fighting several actions—state derivative claims and federal claims—which entails expense and uncertainty for the company," Barnes explains. "Derivative suits are, essentially, 'strike suits.'"

Defending a derivative action can cost a company anywhere from \$250,000 to \$2.5 million, Barnes says. "The corporation often pays just to get rid of the case, like a tax. This involves real money, including the amount

paid to attorneys plus whatever the company has to pay to settle," he says. "Even without discovery, a company can easily incur attorney fees of \$200,000 or more."

With shareholders' attorneys getting 40 percent of any judgment or settlement, shareholder-side lawyers "troll" for plaintiffs, and there's stiff competition among plaintiffs firms to be lead derivative counsel, adds Isabelle Hurtubise, a securities law associate at Bingham McCutchen.

Even if a corporation settles a derivative suit, the company may be forced, as part of the settlement, to institute certain corporate governance measures. Although the end result may be positive, "the company's not instituting these internal changes voluntarily or on its own timing," Barnes says. "They must negotiate the terms with plaintiffs counsel, and pay plaintiffs counsel's fees."

The complexity of litigating derivative suits varies from state to state. Some state courts apply plaintiff-friendly pleading and discovery standards, and others—most notably Delaware—are more corporation-friendly. One of the best illustrations of the differences is the "demand futility" pleading requirement.

Specifically, a derivative-suit plaintiff must make a demand on the corporate board that it bring the action itself, or the plaintiff must allege with particularity the reasons for not making that demand. Shareholders can allege, for example, that the demand requirement is excused because it is futile—since the plaintiff named directors as defendants, they cannot impartially evaluate the claims against them.

Delaware has the most developed body of law concerning demand futility. It applies a two-prong test to determine whether the claim has been adequately pled. In Delaware discovery cannot be used to marshal the facts necessary to establish that the pre-suit demand

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# SECURITIES LITIGATION

is excused. Though plaintiffs may seek books and records under Delaware pleading-discovery rules, they must show by a preponderance of the evidence—a tough standard—that their reason for suspecting mismanagement is credible, and their request must specifically and discretely identify documents sought.

Some California courts, in contrast, have held that simply naming the majority of directors in a derivative suit may be sufficient to show bias such that the pre-suit demand is excused. Furthermore, the right to discovery in California does not depend on the status of the pleadings. In fact, California law authorizes litigants to use discovery—including “fishing expeditions”—precisely to amend pleadings.

“A key difference between California and Delaware is that in California, plaintiffs can likely get into discovery by just naming directors,” Hurtubise explains. “In Delaware, just naming directors isn’t enough. There are stricter requirements for proving why a pre-suit demand was futile. In this sense, Delaware is more like the federal PSLRA.”

Case law surrounding these rules is unsettled in California, Barnes adds. “In Delaware, the standards are more consistent and clearly applied. Plaintiffs must plead facts in great detail,” he says. “California allows fishing expeditions for the specific purpose of amending pleadings. That’s a big deal because discovery is extraordinarily expensive. It can force a company to settle and pay attorneys fees. Delaware created hurdles not necessarily applied in California, which provides increased certainty and decreased risk for corporations defending actions in Delaware.”

Importantly, California courts have declined to apply Delaware law that is directly in conflict with California’s to a Delaware corporation when the corporation is headquartered in California and did significant business in California.

## CHANGING CORPORATE BYLAWS

After Barnes defended a challenging shareholder derivative case, he wondered what a corporation could do to ensure that any future derivative claims against it would be litigated in the most favorable forum. Delaware—with a legislative policy that discourages judicial

interference with corporate decision making—is a far better defense forum than California, and many other states—according to Barnes.

He recommends that corporations amend their bylaws—which are, essentially, a contract between the corporation (the technical plaintiff in a shareholder derivative suit) and its directors—to require Delaware as the forum for derivative lawsuits. “Changing the bylaws may not prevent derivative suits,” Barnes explains, “but because Delaware is a corporation-friendly forum, it may get cases dismissed quickly and cheaply compared to other state courts.”

Although the idea of forum selection sounds “naughty,” according to Hurtubise, courts respect such clauses. “They understand that all the parties know what law is going to be applied. Everyone knows in advance the rules by which they’re playing.” Using the bylaws to designate a forum is, she says, simply an efficient way to enter into an agreement between the corporation and its directors without having to renegotiate and revise dozens of contracts.

This strategy works best for medium and large publicly traded companies or private companies planning to go public. The only downsides to litigating in Delaware, says Barnes, are having to hire local counsel and needing to physically be in Delaware in the rare event the case goes to trial. “The whole strategy of requiring filing there is to get the case tossed out at pleading stage.”

Legitimate derivative claims filed in Delaware will still proceed past the pleading stage, he adds. Requiring Delaware as the forum simply ensures that stricter pleading and discovery standards will apply. ●

Leslie A. Gordon is a former lawyer and a legal journalist in San Francisco.

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The following attorneys were interviewed for this article:



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