SECURITIES LITIGATION 101:

UNDERSTANDING SHAREHOLDER DERIVATIVE LAWSUITS

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Eds: This is the first in a regular series of articles designed to explain some of the ins and outs of investor litigation to non-practitioners.

Over the past few years, companies including Alphabet, Boeing, Pinterest, Victoria's Secret, and Wynn Resorts have agreed to sweeping corporate governance reforms to settle derivative lawsuits brought by their shareholders. Though mainstream news outlets have focused on the behavior that led to these lawsuits and the groundbreaking settlements themselves, we thought it would be helpful to discuss the nature of these "indirect" lawsuits and how they differ from other securities class actions.

Let's start with some differences.

In a traditional securities class action, shareholder plaintiffs sue the company and certain of its officers and directors for violations of securities laws. In a derivative class action, shareholder plaintiffs sue corporate leaders *on behalf of the company* for breaching their fiduciary duty to the company and harming long-term shareholder value. In other words, shareholders "stand in the shoes" of the corporation to protect the present and future value of their stock holdings.

WHILE PLAINTIFFS IN A SECURITIES CLASS ACTION TYPICALLY SEEK TO RECOVER MONETARY DAMAGES DIRECTLY FROM THE COMPANY AND INDIVIDUAL DEFENDANTS, THE GOAL OF A DERIVATIVE LAWSUIT IS TO ADDRESS CORPORATE GOVERNANCE AND/ OR INTERNAL-CONTROL WEAKNESSES THAT EXPOSED THE COMPANY TO REPUTATIONAL AND FINANCIAL DAMAGE.

This leads to another important difference. While plaintiffs in a securities class action typically seek to recover monetary damages directly from the company and individual defendants, the goal of a derivative lawsuit is to address corporate governance and/or internal-control weaknesses that exposed the company to reputational and financial damage. While a settlement may include a financial contribution from defendants or their insurers, that money goes to the corporation—and is frequently tied to commitments to effectuate corporate governance changes to enhance the company's long-term value.

Courts have made clear that before filing a derivative lawsuit it is advisable for a shareholder to first exercise her statutory shareholder rights to seek certain types of documents from the company. This "books and records demand," which takes the form of a letter sent to the company's Board of Directors, seeks internal non-public documents that enable a shareholder to better evaluate her concerns and, if warranted, file a derivative lawsuit with allegations supported by the documents the company produces.

DERIVATIVE LITIGATION IS AN INTERESTING OPTION FOR PENSION FUNDS OF ALL SIZES WHO ARE INTERESTED IN PROTECTING THE LONG-TERM VALUE OF THEIR HOLDINGS BY ADDRESSING SHORTCOMINGS IN A VARIETY OF AREAS, INCLUDING CORPORATE GOVERNANCE, WORKPLACE SAFETY, ENVIRONMENTAL COMPLIANCE, DEI, AND CYBERSECURITY.

It is also worth noting that derivative lawsuits must clear a high bar early in the proceeding. Plaintiffs must convince the court that it was necessary to file the lawsuit; merely demanding that the Board of Directors make the necessary governance changes would be “futile” because the directors are insufficiently independent to correct the wrongdoing. In some cases, the documents produced by the corporation in response to a books and records demand may provide support for why a pre-suit demand on the board would be futile.

Unlike federal securities litigation, derivative lawsuits are not subject to the Private Securities Litigation Reform Act of 1995 (PSLRA), which directs judges to select as lead plaintiff the movant or movants with the largest presumptive losses, if they are typical and adequate class representatives. In derivative litigation, the “relative economic stakes of the competing litigants in the outcome of the lawsuit” is just one of six factors judges use to select lead plaintiffs. So sophisticated institutional investors who may not have the largest position in the company may be appointed based on the quality of their legal pleadings, ability to represent the class, willingness to lead the case, and selection of counsel, among other factors, providing they pledge to remain shareholders throughout the litigation.

All these characteristics make derivative litigation an interesting option for pension funds of all sizes who are interested in enhancing the long-term value of their holdings by addressing shortcomings in a variety of areas, including corporate governance, workplace safety, environmental compliance, DEI (diversity, equity, and inclusion), and cybersecurity. ■

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