

Shareholder Derivative Suits Likely To Extend to COVID-19, Racial Equality

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As the last few years have shown, shareholder derivative litigation — claims brought by a shareholder purportedly on behalf of a company against its board of directors or senior management for alleged breaches of fiduciary duty — is often brought following the public disclosure of a negative event (so-called “event-driven litigation”). When multiple companies reported the departure of executives in the wake of #MeToo allegations, their boards faced shareholder derivative suits related to the adequacy of the company’s sexual harassment policies or board-level monitoring. Often, litigation also follows when companies disclose data breaches, with claims that the boards of those companies should have prevented the breaches. Event-driven litigation is a trend that will likely continue. In particular, companies should expect to see derivative suits related to allegations surrounding COVID-19 and structural racism filed over the next year. Although it is yet to be seen whether such event-driven litigation will be successful, litigation enhances risk and can be disruptive to boards and management even if the claims ultimately fail. Thus, boards should carefully consider their disclosures, practices and procedures related to these issues.

Shareholders have already filed securities class actions accusing companies of failing to disclose or downplaying the risks related to the COVID-19 pandemic, failing to disclose or misrepresenting the extent to which it has affected the company’s operations or financial results, or making false statements about or products related to COVID-19. According to the Stanford Law School Securities Class Action Clearinghouse, as of September 3, 2020, 16 such cases have been filed since March 2020 against a variety of travel, health care, technology and financial services companies. These cases are all in their preliminary stages, so it is not clear whether any of these claims will be successful. Regardless, after a securities class action is filed, another shareholder often files a derivative action, alleging that the board breached its duty of oversight by failing to prevent the alleged violations of the securities laws.

Separate from disclosure-related claims, boards may face derivative suits related to the company’s preparation for and/or response to the pandemic, including claims that the company failed to: take adequate precautionary measures to prevent the spread of COVID-19 among employees or customers, take steps to mitigate risk (such as preserving liquidity and cutting costs) or otherwise minimize disruptions to operations. If the company’s allegedly inadequate response results in business or reputational losses or other liability, derivative suits claiming that the board breached its duty of oversight are a risk.

Indeed, litigation arising from the COVID-19 pandemic is already widespread, with dozens of class action suits already filed in a variety of areas. Employees have brought class action suits accusing their employer of failing to comply with employment laws related to terminations or employee safety during the pandemic. Consumers have brought suits alleging price gouging of highly sought-after items such as hand sanitizer and toilet paper, seeking refunds of recurring fees, or seeking refunds of tickets for events or trips that were canceled due to the health crisis. If a company incurs significant liability as a result of such a suit, a derivative suit claiming that the board failed to take proper steps to prevent the liability may follow.

Another area where boards and management may face event-driven litigation is with respect to allegations of structural racism. Amid a burgeoning nationwide movement against anti-Black racism, at least six such lawsuits have been filed, according to the blog *The D&O Diary*, which covers director and officer liability issues. The lawsuits

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contend that, while the company states in general terms that it is committed to diversity and inclusion, its board and senior management are not sufficiently diverse, and the board has not made adequate efforts to increase diversity. The suits assert claims for breach of the duty of candor and violation of the federal securities laws governing proxy disclosure, purportedly on behalf of the companies. Some courts have rejected similar disclosure-related claims based on aspirational statements or general descriptions of policies. For instance, the U.S. Court of Appeals for the Second Circuit in *Singh v. Cigna Corp.* in 2019 held that generic statements about regulatory compliance do not give rise to a securities fraud claim. Two years before that, the U.S. Court of Appeals for the Ninth Circuit, in *Retail Wholesale & Dep't Store Union Local 338 Ret. Fund v. Hewlett-Packard Co.*, affirmed dismissal of securities fraud claims based on the company's description of its ethical code. Thus, whether the suits will proceed past the pleading stage, let alone achieve success, is yet to be seen. However, to the extent the suits succeed, the trend may broaden.

A claim that the board failed to exercise proper oversight to prevent harm is typically called a “*Caremark* claim,” named for the seminal 1996 Delaware case, *In re Caremark Int'l Inc.*

Derivative Litigation. A shareholder asserting such a claim generally must prove “the directors completely fail[ed] to implement any reporting or information system of controls, or having implemented such a system or controls, consciously fail[ed] to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention,” as stated in the 2019 Delaware case *Marchand v. Barnhill*. Proof of mere negligence is not enough, and breach of the duty of oversight claims have a limited track record of success. Because a board that makes a good-faith effort “to put in place a reasonable board-level system of monitoring and reporting” will avoid liability, oftentimes boards successfully obtain dismissal of a *Caremark* claim if they have such systems in place.

Thus, to minimize the risk of event-driven shareholder derivative litigation, boards are well advised to actively monitor the company's response to and disclosures about COVID-19 and to position themselves to anticipate and proactively address any issues before they arise. Likewise, to the extent they have not already done so, companies lacking diversity on their boards or in their senior management may consider this an opportune time to revisit their policies, practices and disclosures related to diversity.