



Supreme Court Nominee and the Derivative Suit

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In an opinion from 2008, Judge Kavanaugh, writing for the U.S. Court of Appeals for the District of Columbia, offered a rare glimpse into his views on the demand requirement in derivative litigation under Delaware law, and hinted in *dicta* that he may be open to reevaluating the legal standard for reviewing a dismissal of derivative claims based on a lack of demand. Given Judge Kavanaugh's nomination to the Supreme Court, this post summarizes his analysis on this critical issue.

Judge Kavanaugh Affirms Dismissal Based on Lack of Demand, and Confirms Substantial Hurdles Faced by Plaintiffs In Derivative Actions.

In *Pirelli Armstrong Tire Corp. Retiree Med. Benefits Tr. ex rel. Fed. Nat. Mortg. Ass'n v. Raines*, 534 F.3d 779, 782 (D.C. Cir. 2008), *abrogated by Lightfoot v. Cendant Mortg. Corp.*, 137 S. Ct. 553, 196 L. Ed. 2d 493 (2017),¹ plaintiffs, who were shareholders of Fannie Mae, brought a derivative action against the company's directors arising out of the company's misapplication of accounting standards, and the board's approval of certain executives' severance compensation.

The plaintiffs alleged that demand was excused as futile pursuant to Fed. R. Civ. P. 23.1. *Id.* at 783. Specifically, the plaintiffs argued that a majority of the 13-member Board was not disinterested and independent because:

- “there is a “substantial likelihood” that a majority of the directors would be liable on the accounting-related claims for failure to exercise proper oversight”;
- “the directors did not exercise valid “business judgment” in approving the severance arrangements for” two executives whom the plaintiffs alleged should have been terminated for cause; and
- “there was a ‘reasonable doubt’ about a majority of the Board’s ‘independence’ to consider a demand in light of the various

¹ The decision was abrogated on grounds not relevant to this analysis, concerning the scope of jurisdiction conferred by the sue-and-be-sued clause of Fannie Mae's charter.

professional, charitable, and personal entanglements among Board members.”

Id. at 788-89.

In analyzing the plaintiffs’ complaint, Judge Kavanaugh repeatedly emphasized the substantial burden faced by plaintiffs in attempting to establish demand futility. With respect to plaintiffs’ accounting-related claims, which were based on the board’s failure to oversee the accounting process, Judge Kavanaugh noted that liability predicated on a board’s failure to exercise oversight “is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.” *Id.* at 789 (citing *In re Caremark Int’l, Inc. Derivative Litig.*, 698 A.2d 959, 967 (Del.Ch.1996)). Judge Kavanaugh found that the directors were insulated from liability because they relied on the opinions of outside experts. *Id.* at 790.

With respect to the severance-related claims, Judge Kavanaugh stated that “[t]he business judgment rule establishes a ‘presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.’” *Id.* at 791 (citing *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)). Judge Kavanaugh held that the plaintiffs failed to allege sufficiently particularized facts demonstrating that “the directors acted without adequate information or deliberation.” *Id.* at 792. Judge Kavanaugh noted that the decision to permit the executives to be terminated without cause was made after a series of board meetings held over several days, and that under Delaware law, “[e]ven if the directors had grounds to invoke the ‘for cause’ termination provisions, the directors reasonably could have decided not to invoke those provisions” *Id.* at 792.

In analyzing plaintiffs’ claims that the directors lacked the necessary independence based upon their personal and professional entanglements, Judge Kavanaugh explained that plaintiffs face a “very high bar” when attempting to establish a lack of independence based on directors’ experience, accomplishments, wealth, and connections:

Directors tend to be experienced and accomplished business persons; those individuals also tend to be comparatively wealthy and have a wide range of professional and charitable affiliations and relationships. It is usually considered in the interests of corporations and their shareholders to attract experienced and accomplished business leaders as directors. So as not to preclude service by such persons, Delaware law creates a very high bar for using the kinds of relationships alleged here as a basis for finding a lack of independence and thereby excusing demand in a derivative suit.

Id. at 793–94.

Judge Kavanaugh found that the business, personal, and professional relationships among the directors were “commonplace,” and were “not remotely sufficient under Delaware law to disqualify the challenged directors from evaluating demand in an independent manner.” *Id.* at 794.

Based on the foregoing analysis, Judge Kavanaugh affirmed the district court's judgment dismissing the complaint.

Judge Kavanaugh Hints That He May Be Open to Reevaluating the Legal Standard for Reviewing a Dismissal for Lack of Demand.

Perhaps most intriguing, Judge Kavanaugh stated in *dicta* an apparently plaintiff-friendly position regarding the legal standard for reviewing a district court's dismissal based on a lack of demand. He noted that under *Gaubert v. Fed. Home Loan Bank Board*, 863 F.2d 59, 68 n. 10 (D.C.Cir. 1988), the Circuit court reviews a dismissal for lack of demand under an abuse-of-discretion standard. But Judge Kavanaugh stated that “[w]e tend to agree with plaintiffs that an abuse-of-discretion standard may not be logical in this kind of case, however, because the question whether demand is excused turns on the sufficiency of the complaint's allegations; and the legal sufficiency of a complaint's allegations is a question of law we typically review de novo.” *Pirelli Armstrong Tire Corp.* at 783 n.2. Ultimately, Judge Kavanaugh found that there was no need to consider this aspect of *Gaubert* because the court would affirm the district court's decision even under de novo review. *Id.*

Judge Kavanaugh has rarely written decisions on the topic of derivative litigation. The *Pirelli Armstrong Tire Corp.* opinion offers some interesting insight into Judge Kavanaugh's thoughts on this area of law and, with respect to his *dicta* regarding the proper standard for review, an indication that Judge Kavanaugh may be willing to take another look at existing precedent, should he be confirmed to the Supreme Court.