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Record shareholder settlements pressure directors and officers

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Record settlements will shape the direction of shareholder derivative litigation in 2015 and beyond. Stephanie Resnick and John C. Fuller, corporate governance attorneys at Fox Rothschild L.L.P., explore the situation and see some relief in the form bylaws that shift legal fees.

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In 2015, trends in shareholder litigation are certain to be affected by two recent developments. First, the stakes for directors and officers, and their insurers, rose significantly when two shareholder derivative actions were settled last year for $275 million and $154 million, respectively — two of the largest settlements in history. Second, at the same time, courts have increased the risk for shareholders bringing derivative actions by upholding fee-shifting bylaws, which allow corporations to seek legal fees from unsuccessful shareholder plaintiffs.

At first blush, these two developments appear to be inconsistent. However, their combined effect may create a new equilibrium in shareholder derivative litigation, in which both sides have more at risk than ever before.

Corporations and shareholders will closely monitor "test" cases, which will define how broadly fee-shifting bylaws will be accepted, as well as potential legislative responses. However, directors, officers and their insurers must keep in mind the massive awards of the past year when approaching any shareholder dispute. Until courts fully realize significant disincentives to unsuccessful shareholder plaintiffs, the tendency is that courts will continue to approve record-setting settlements.

Record-setting settlements

In November 2014, the largest shareholder derivative settlement ever, $275 million, was announced in an

action brought against video-game maker Activision Blizzard, Inc. in the Delaware Chancery Court.

The Activision lawsuit involved an $8 billion transaction in which two of Activision's senior officers used an outside entity to secretly take a controlling interest in Activision. Through the entity, the officers purchased a substantial portion of Activision's outstanding stock from Activision's controlling shareholder, French media conglomerate Vivendi S.A.

In a statement after the announcement of the settlement in the suit alleging breach of fiduciary duty, Activision said the settlement would be paid by “multiple insurance companies, along with various defendants.” Some $207 million of the settlement amount is to be paid by Activision's directors and officers and their insurers, while $67.5 million will come from Vivendi.

The second massive shareholder derivative settlement involved fuel exploration company Freeport-McMoRan Inc. The $154 million settlement was first announced in late 2014 and approved by the Delaware Chancery Court in April 2015. The settlement resolved a dispute regarding alleged conflicts of interest among Freeport board members when the company purchased McMoRan Exploration Co. and another company for $9 billion in 2013. The shareholders alleged that the conflicts of interest led to Freeport paying an inflated price to acquire the two companies.

Though none of the defendants admitted liability, according to the settlement agreement, Freeport's D&O insurers will pay $115 million of the settlement, while the Freeport will contribute $22.5 million and Credit Suisse, the financial advisors to Freeport's board during the transaction, will supply the remaining amount through a combination of cash and credits to Freeport.

To reimburse the shareholders, the settlement proceeds, less attorneys' fees, will be paid in a special dividend. The payment of a special dividend is unusual because most successful derivative actions, which are brought on behalf of the corporation, result in payments made to the company.

Whether a settlement structure that involves the use of dividends to distribute proceeds to shareholders will become commonplace is hard to determine, but it does show potential for making shareholders whole when there has been a clearly discernible injury to the value of their investment.

It is also difficult to say what has prompted the trend of massive shareholder derivative settlements. Perhaps most troubling for directors and officers, and their insurers, is the emboldening effect such settlements may have on plaintiffs attorneys as they approach the settlement table.

Fee-shifting bylaws

In the face of record settlements in shareholder derivative actions, the potential liability for directors and officers may never have been higher. However, 2014 also saw the advent of fee-shifting bylaws that raise the stakes for shareholders and that, hopefully, will create a deterrent against plaintiffs who seek the next mega-award.

Fee-shifting provisions in bylaws allow corporations to seek legal fees from shareholders who bring unsuccessful derivative actions. Such provisions were upheld as facially valid by the Delaware Chancery Court in *ATP Tour Inc. v. Deutscher Tennis Bund*.

ATP Tour is a Delaware membership corporation that includes professional tennis players and the owners of professional tennis tournaments. In 2006, ATP amended its bylaws so if a member brought an action against the ATP but did not obtain a judgment on the merits that “substantially achieved” the remedy sought, the member would be required to reimburse ATP for all attorneys fees, costs and expenses.

In 2007, after the ATP moved two national tennis federations to a lower tier of competition, the federations sued ATP and its directors, claiming antitrust violations and breach of fiduciary duty. ATP and the directors prevailed and moved to recover fees and costs under its bylaws.

Though ATP is a non-stock corporation, the reasoning and broadly applicable precedents cited by the court likely indicate that the decision will be applied to Delaware stock corporations. The ruling reinforces the concept that bylaws are part of the contract between a corporation and its interest holders and that the contract may be amended when proper procedures are followed.

As expected, the ramifications of the *ATP Tour* decision already are being tested by corporations amending their bylaws to limit their exposure and shareholders seeking to secure their right to sue. For example, in *Kastis et al. v. Carter et al.*, before the Delaware Chancery Court, the shareholders filed a motion to invalidate the fee-shifting bylaw adopted just days after *ATP Tour* was decided. Significantly, the bylaw provision at issue in *Kastis* provided for the payment of fees in any unsuccessful litigation that began or continued after the bylaw was adopted. Unfortunately, the court declined to hear arguments on the validity of the bylaw, finding that it was inapplicable to the issues in that case.

Delaware takes a stand

As additional challenges arise without clear resolution, the Delaware Legislature has also recently taken up the issue of fee-shifting bylaws. On May 12, 2015, the Delaware Senate passed S.B. 75, which would prohibit fee-shifting provisions in the bylaws of stock corporations. The bill is currently under consideration by the Delaware House of Representatives.

The record-setting settlements of 2014 present a troubling trend for directors and officers. With the sky as the apparent limit for shareholders, the only glimpse of a silver lining from the year for directors and officers are fee-shifting bylaws. This year, all insurers should be tuned to the Delaware courts and the Delaware Legislature to see whether such bylaws will be accepted in other corporate forms and with what scope bylaws can be used to insulate directors and officers from impending, or even ongoing, litigation.

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Redefining the role of the outside counsel litigator

What are four characteristics that general counsel should look for in their outside litigation team?

BY STEPHANIE
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General counsel should look for four important qualities in their outside counsel: The first is being an outstanding and ethical lawyer. The second is exhibiting responsiveness. The third is offering a practical and cost-effective approach. The fourth is being a tireless advocate for your client.

As to what defines an "outstanding" lawyer, general counsel should insist that their external legal team be:

- Knowledgeable and up-to-date on the latest developments in the law
- In possession of sound and reasoned judgment to help guide the organization through the litigation process
- Able to place a litigation matter in the proper perspective, meaning being able to sift through issues, assigning levels of urgency so as to plan, prioritize and execute the most advantageous and efficient approach

An additional, paramount quality is that outside counsel truly understand a client's short-, medium- and long-term business plans as well as its day-to-day business practices and culture. Cost-efficiency is being able to help a client go from "Point A" to "Point B" via a pragmatic, efficient strategy.

It is not enough for outside counsel to be purely high-wattage intellects; they also need to be superior tacticians, outstanding communicators and budget watchdogs. External legal teams need to serve as a seamless extension of a company's in-house counsel capacities.

How has technology changed litigation? In particular, how does the e-discovery process impact collaboration between general counsel and a company's external legal team?

Technology has exponentially changed litigation, making discovery much more extensive and expensive and thus more difficult to litigate a case. Real pressure is felt by small-to-midsize businesses. Oftentimes, there is a question as to whether a company has the ability to adequately fund litigation in light of e-discovery challenges. Pressure is also felt by large companies who must hold and cull data from a variety of sources in temping to day-to-day business processes. The technical nature of e-discovery, coupled with the need to retain outside service providers, makes litigation far more complex.

Where is the "walk away" point, when litigation is projected to be too expensive and too resource-intensive? When should GCs settle, knowing that losing one battle is better than fighting a war?

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The "walk away" point exists and is best identified when outside counsel work in a collaborative manner with general counsel. A company's business interests and longevity, at all times, must remain paramount. The role of outside counsel is to provide options. Taking a case through trial is one option, and outside counsel and their firms should pride themselves on their ability to try cases. However, situations can occur throughout the course of an engagement when the most logical solution is to settle a matter, due to factors including projected cost and impact to a company's ongoing business operations. Outside counsel's charge is to provide a detailed analysis of each situation, with recommendations at certain "windows" in a case with final determination of strategy ultimately left to inside counsel and the client.

A good litigator always takes the time to understand and scrutinize a matter from all angles, looking to determine early in the process if a dispute can be resolved favorably without costly litigation. Settling cases under appropriate circumstances does make sense. Ultimately, a review needs to be made as to the potential economic consequences of going to trial. Outside counsel should always be mindful of the potential economic hardship of defending a claim. Having said this, certain claims just need to be defended and tried.

The "walk away" point is really a subjective matter that varies from case to case. At times, a company's choice to pursue litigation is about more than cost. It is about defending its business practices, an issue that can trump strict economics. Of course, a risk in any litigation is when a company's leadership and outside counsel both become emotionally enmeshed in an issue. The role of outside counsel is to always be as measured and reasonable as possible, truly looking at a matter with an open mind, determining what the best course of action is — early resolution, resolution or going to trial.

How have companies increasingly structured external legal teams to include litigators at an early stage in matters involving mergers and acquisitions?

General counsel need to consider all the dimensions of a potential deal. This is why a multi-disciplinary legal team, including a litigation component, is critical. While in the short-term, costs may be higher than if deal terms and evaluation are done solely by transactional attorneys, ultimately the benefit of avoiding potential issues in the long-term outweighs this modest financial expense.

For instance, from a labor and employment perspective, a deal can contain numerous potential red flags. These include issues with meshing two employment policies harmoniously, devising a proper strategy for possible layoffs and planning for potential fallout, and not fully understanding pending or emerging employment concerns that are potentially very real liabilities at play. The deal terms need to be scrutinized intensely. The goal for general counsel and outside counsel is avoiding major litigation down the road. An ounce of prevention truly can make all the difference. Similarly, in a merger or acquisition situation, there are a host of other legal issues that would benefit from a litigator's scrutiny.

It is absolutely true that litigators do see the world and transactional matters differently than their colleagues who focus more narrowly on specific aspects of the law. This is one of the main reasons why law firms stress cross-disciplinary, holistic approaches for clients. The perception of a litigator as the surgeon called in for serious, exigent needs only is fading. While good litigators are precise, efficient and effective operators, they are also concerned with their clients on a day-to-day basis.

General counsel should view outside counsel as a complementary asset and true team members of an organization.

Stephanie

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