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[Courts Should Firmly Reject Shareholder Activists' Breach of Fiduciary Duty Derivative Suits](#)

July 26, 2010 - 8:51 am



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Two weeks ago, Pfizer Inc. was hit with a stockholder derivative lawsuit in a Delaware court, arising out of its September 2009 settlement of federal allegations that it improperly promoted several of its drugs. The filing was hardly surprising. Other shareholder derivative suits motivated by the federal settlement have been filed against Pfizer, and [several](#) have been consolidated in a New York federal court.

But if lawyers stopped to take a closer look at their legal theory, they would realize that such stockholder derivative suits stand little chance of success – unless success is measured as the ability to extort settlement payments from litigation-averse corporations. Stockholder derivative suits are intended to allow a corporation to recover funds from unfaithful directors, not to punish directors for the wrongdoing of corporate employees.

Derivative actions provide shareholders a means to protect a corporation's interests when the corporation is injured by breaches of fiduciary duty by directors and/or officers. One such fiduciary duty is the duty of loyalty; for example, when a corporation has an opportunity to profit from business dealings, a director breaches his duty of loyalty if he diverts the opportunity to himself for his personal profit. The number of stockholder derivative suits mushroomed after the Delaware courts ruled that the duty of loyalty requires a director to adequately oversee the corporation's day-to-day business practices.

But as a just-released [Washington Legal Foundation Working Paper](#) demonstrates, the courts have interpreted the "duty of oversight" far more narrowly than have plaintiffs' lawyers. It is not enough for a plaintiff in a derivative action to equate a bad outcome with bad faith. So long as directors, in the exercise of their business judgment, have made a good-faith effort to install a

reporting system designed to ensure that information about the corporation's ordinary operations comes to their attention, they cannot be found to have violated their fiduciary duty of loyalty/oversight.

The boards of every major pharmaceutical company, including Pfizer, have long had in place extensive reporting systems designed to keep the boards informed of day-to-day operations. Such systems will never be able to prevent all violations of federal regulatory requirements, but simply because violations occur is not a reason to conclude that an outside director has been disloyal to the corporation. Thus, for example, a federal district court recently threw out a stockholder derivative suit filed against the directors of Cephalon, Inc. The suit alleged breach of the duty of oversight following Cephalon's \$425 million settlement of federal claims that it improperly promoted three of its pharmaceutical products. The court held that the suit was unmeritorious in the absence of detailed allegations demonstrating that the Cephalon board consciously chose to do nothing about illegal activity it knew (or should have known) to exist. See *King v. Baldino*, 648 F. Supp. 2d 609 (D. Del. 2009).

A few more such decisions should help to stem this unwarranted tide of stockholder derivative suits. It is difficult to see how such suits – nominally designed to benefit the corporation – end up benefitting anyone other than the plaintiffs' lawyers. One of the best ways to ensure that corporations comply with federal and state laws is to encourage them to elect to their boards intelligent and independent-minded individuals who will carefully oversee the corporations' activities. But such individuals will be increasingly unwilling to accept directorships if they anticipate that they will be sued for damages every time the corporation runs afoul of a regulatory requirement.

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