



## EIGHTH CIRCUIT AFFIRMS STRICT PLEADING STANDARD FOR SHAREHOLDER DERIVATIVE LAWSUITS

by Professor Amy Deen Westbrook

On April 21, 2012, the *New York Times* (*NYT*) published an article detailing alleged bribery of Mexican officials in violation of the US Foreign Corrupt Practices Act (FCPA) by executives at Wal-Mart de México (Wal-Mex).<sup>1</sup> The article triggered over a dozen lawsuits against Wal-Mart, including shareholder derivative suits alleging that the failure of directors and executives to protect shareholder value constituted breaches of fiduciary duties. The derivative suits were consolidated into two actions, one in federal district court in Arkansas and one in state court in Delaware. The litigation, combined with the costs of Wal-Mart's own investigation and overhaul of its compliance procedures, has apparently cost the company hundreds of millions of dollars.<sup>2</sup>

On July 22, 2016, in *Cottrell v. Duke*, the US Court of Appeals for the Eighth Circuit affirmed the district court's dismissal of one of the consolidated derivative suits.<sup>3</sup> As discussed below, the case exemplifies both the considerable barriers shareholder derivative suits face and the high cost of defending against such suits.

### Facts Alleged by the Shareholder Plaintiffs

The shareholders' claims, taken as true by the courts in the context of the Wal-Mart defendants' motions to dismiss, are based on bribes orchestrated by Wal-Mex executives and general counsel that were paid to Mexican officials to expedite regulatory approvals in the early 2000s. The plaintiffs allege that in 2005 a former Wal-Mex executive reported the payment "irregularities" to the Wal-Mart International general counsel,<sup>4</sup> who looked into the allegations and informed Wal-Mart's senior management.

Wal-Mart then consulted an outside law firm, which proposed an extensive investigation. Instead, however, Wal-Mart had its in-house Corporate Investigations Unit conduct a preliminary inquiry. The shareholders allege that Corporate Investigations found evidence supporting the claims, drafted a report finding reasonable suspicion to believe US and Mexican laws had been violated, and recommended a full investigation. Under the Wal-Mart charter, such a report must be shared with management, but who actually saw it is unclear. Meanwhile, unhappy with the Corporate Investigations inquiry, Wal-Mex officials complained to the Vice-Chairman of Wal-Mart's International Division, Michael Duke (later Wal-Mart's president and CEO), and in February 2006 Wal-Mart's then-CEO, H. Lee Scott transferred the matter to Wal-Mex itself. The Wal-Mex general counsel quickly wrapped up the inquiry, exonerating himself and other executives.

<sup>1</sup> David Barstow, *Vast Mexican Bribery Case Hushed Up by Wal-Mart After Top-Level Struggle*, N.Y. TIMES, Apr. 21, 2012, at A1.

<sup>2</sup> The author's estimate is based on Wal-Mart Quarterly Reports filed from 2013-2016.

<sup>3</sup> *Cottrell v. Duke*, No. 15-1869, 2016 WL 3947811 (8th Cir., July 22, 2016).

<sup>4</sup> *Id.* at \*1.

At some point, the former executive who originally reported the irregularities shared his story with the press, and in 2011, when the *NYT* investigation became known, Wal-Mart launched a new investigation. Wal-Mart informed the US Department of Justice (DOJ) and the Securities and Exchange Commission (SEC) of its investigation and disclosed its responses in its December 2011 SEC filing.<sup>5</sup> Nevertheless, when the *NYT* article was published on April 21, 2012, derivative lawsuits followed within days.

## The Lawsuits

In the derivative lawsuits, shareholders who held shares when the *NYT* article was published sought damages from current and former directors and officers of Wal-Mart, alleging that the directors and officers broke state and federal laws by permitting and then covering up bribery committed on behalf of Wal-Mart. Normally, a corporation's board of directors would bring suit to enforce a corporation's rights. In derivative suits, however, shareholders allege that it is the directors (and officers) *themselves* who have harmed the corporation. Before a derivative suit may proceed, *i.e.*, before shareholders may usurp the board's responsibility to sue on behalf of the corporation, shareholders must first "demand" that the directors cause the corporation to pursue the matter. If the board decides that the corporation should not pursue the claim, however, the board's decision is protected by the business judgment rule, under which courts generally defer to the board's judgment, thereby extinguishing the shareholders' suit.

Since making a demand is tantamount to abandoning the claim, the law provides another option: instead of making a demand, shareholders can sue and "state with particularity" any efforts they took to "obtain the desired action from the directors" or, more importantly, "the reasons for not obtaining the action or not making the effort."<sup>6</sup> The plaintiffs can demonstrate that a demand would have been "futile." Courts, especially those applying Delaware law, do not accept a simple "demand would have been futile" assertion. Instead, shareholders must plead specific facts that support their assertion of demand futility. This is a high bar.<sup>7</sup>

As in most derivative litigation, the Wal-Mart defendants sought to dismiss the suit based on the shareholders' failure to make a demand and the inadequacy of the shareholders' demand-futility pleadings. On March 31, 2015, a federal judge in Arkansas dismissed the suit, and the shareholders appealed.<sup>8</sup>

## The Eighth Circuit Decision

On July 22, 2016, the Eighth Circuit affirmed. The opinion is notable for two reasons:

1. *The Eighth Circuit Upheld Strict Requirements for Alleging Demand Futility* The Eighth Circuit upheld the district court's strict interpretation of the requirement that shareholders who do not make a demand on the board cannot bring a derivative suit unless their "particularized factual allegations... create a reasonable doubt that, as of the time the complaint [was] filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand."<sup>9</sup> As in many derivative suits, the shareholders alleged that a majority of directors could not exercise their business judgment because there was a substantial likelihood that, if the shareholders' suit was successful, those directors would be personally liable.<sup>10</sup> Because the directors' decision on the demand would be motivated by self-interest, rather than in the interest of the company, demand would be futile.

<sup>5</sup> Wal-Mart Stores, Inc., Quarterly Report (Form 10-Q) (Dec. 6, 2011).

<sup>6</sup> FED R. CIV. PRO. 23.1(b)(3).

<sup>7</sup> See Amy Deen Westbrook, *Double Trouble: Collateral Shareholder Litigation Following Foreign Corrupt Practices Act Investigations*, 73 OHIO ST. L. J. 1217 (2012).

<sup>8</sup> *In re Wal-Mart Stores, Inc. Shareholder Derivative Litigation*, No. 4:12-cv-4041, 2015 WL 1470184 (W.D. Ark., Mar. 31, 2015).

<sup>9</sup> *Cottrell* at \*3 (citing *Rales v. Blasband* 634 A.2d 927, 934 (Del. 1993)).

<sup>10</sup> *Id.* at \*6 (quoting *Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1984)).

Applying Delaware law,<sup>11</sup> Chief Judge William Riley required the shareholders to plead particularized facts showing that a majority of the Wal-Mart directors on the board in 2012 faced potential personal liability for violating their fiduciary duties because they were aware of the misconduct at Wal-Mex and allowed or enabled a Wal-Mart cover up. Of the 15 directors on the Wal-Mart board in 2012, when the derivative suits were filed, nine were on the board in 2005 and 2006 during the investigation into the Mexican payments. Of the nine continuing directors, two of them (Duke and Scott) dealt directly with the investigation and were therefore not disinterested. For Chief Judge Riley, the issue was whether the shareholders pleaded:

“particularized facts”—as distinct from “conclusory allegations”—supporting ‘reasonable factual inferences’ that the other seven continuing board members learned of the suspected bribery before word of the *New York Times* investigation got out and Wal-Mart began scrambling to do what it allegedly should have done from the beginning.<sup>12</sup>

If the other seven continuing directors knew of bribery and consequently faced personal liability, then a majority of the board had a personal interest in not bringing suit on behalf of the corporation, in which case a shareholder demand would have been futile and thus excused. The defendants’ motion to dismiss then would be denied, allowing the derivative suit to proceed.

The shareholders offered three theories for how knowledge of the illicit payments reached the directors in question. First, in late 2005, Wal-Mart’s investigators reported preliminary findings to the board’s audit committee, headed by Roland Hernandez, who alerted the full board. The Eighth Circuit found that it was reasonable to infer that Hernandez received the report, but the court declined to infer that Hernandez told the board. The shareholders maintained that certain officers were in a “reporting relationship” to the board, but the court required “specific factual allegations establishing Hernandez ‘*did in fact report* to specific directors.’”<sup>13</sup> Chief Judge Riley relied on the logic of a Delaware Supreme Court decision in the parallel books-and-records litigation brought by the shareholders against Wal-Mart in the Delaware derivative suit. The Delaware court held that *what* officers disclosed when they reported to directors could be inferred from a reporting relationship, but *whether* officers actually reported to directors could not be so inferred.<sup>14</sup> Chief Judge Riley similarly explained:

The shareholders’ position thus boils down to the same logic Delaware courts have consistently rejected, namely the inference that directors must have known about a problem because someone was supposed to tell them about it. In the context of a derivative suit involving a Delaware corporation, we refuse to assume so much.<sup>15</sup>

The requirement or even likelihood of a report could not replace particularized allegations that a report was actually made.

The plaintiffs offered two more theories for how the directors knew about the irregularities in Mexico. Their second theory was that senior officers besides Hernandez told the board. Their third was that the bribery at Wal-Mex was so large and important that the Wal-Mart board must have known. The Eighth Circuit made short work of both theories, reasoning that each lacked specific factual allegations.

The refusal of the Eighth Circuit to infer board knowledge without specific factual details in the shareholders’ complaint may represent a nearly insurmountable barrier to derivative suits. Without specific information, successfully detailing the directors’ breaches of fiduciary duty with the precision needed to show that the directors risked personal liability is very difficult.

<sup>11</sup> Wal-Mart is incorporated in Delaware.

<sup>12</sup> *Cottrell* at \*4 (citing *Brehm v. Eisner*, 746 A.2d 244, 255 (Del. 2000)).

<sup>13</sup> *Id.* at \*5 (citing *Wal-Mart Stores, Inc. v. Ind. Elec. Workers Pension Tr. Fund IBEW (IBEW)*, 95 A.3d 1264, 1273 (Del. 2014) (emphasis added by the Eighth Circuit)).

<sup>14</sup> *Id.* at \*5.

<sup>15</sup> *Id.* at \*8.

2. *Derivative Litigation in Delaware May Now Be Precluded* Western District of Arkansas Judge Susan Hickey granted Wal-Mart's motion to dismiss before the plaintiffs in the Delaware suit completed their books-and-records litigation to obtain specific details from Wal-Mart about the alleged payments and the Wal-Mart investigation. Presumably, the Delaware plaintiffs were seeking the particularized facts necessary to survive a motion to dismiss like the one that ended the Arkansas case.

On May 13, 2016 the Delaware Chancery Court granted the Wal-Mart directors' motion to dismiss, based on Arkansas law regarding issue preclusion,<sup>16</sup> finding that the issue considered in Arkansas federal court was the same as the issue in Delaware.<sup>17</sup> The Delaware plaintiffs have appealed to the Delaware Supreme Court. If it affirms, the Delaware Supreme Court will strengthen the proposition that a board needs to litigate only one derivative action based on a single set of facts. It will also provide a substantial incentive for plaintiffs who are sometimes called "fast filers," pitting them against shareholder plaintiffs who seek more detailed information. Given the time that a books-and-records request may take, the first suit to be filed, which may be insufficiently detailed to overcome the demand-futility hurdle, may be the suit most likely to be litigated.

### Ongoing Legal Scrutiny

Wal-Mart has not yet laid to rest the allegations of Wal-Mex irregularities. Non-derivative suits against Wal-Mart and Wal-Mex stemming from the alleged Wal-Mex payments are ongoing. In *City of Pontiac General Employees' Retirement System v. Wal-Mart Stores, Inc.*, also in the Western District of Arkansas, Wal-Mart is defending a securities-fraud class action alleging violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934. On October 6, 2016, Wal-Mart petitioned for permission to appeal Judge Hickey's recent certification of the class to the Eighth Circuit.<sup>18</sup>

DOJ and SEC investigations into third-party payments made by Wal-Mart are also ongoing, and they have expanded to look at Wal-Mart subsidiaries in India and China. Although recent media reports suggest that Wal-Mart may settle the DOJ and SEC FCPA investigations for a substantial sum,<sup>19</sup> the government itself has made no official comment about the status of its investigations.

For its part, Wal-Mart has responded to its alleged shortcomings by establishing an extensive, unified global ethics and compliance program that addresses over a dozen subjects ranging from anti-corruption to food safety to privacy across the company's markets.

As these ongoing developments reflect, businesses that attract FCPA enforcement attention face costly, ongoing regulatory and legal scrutiny even after the negative publicity of the initial investigations have subsided. That said, if courts continue to apply strict demand-futility pleading requirements, shareholder derivative litigation risk may begin to ebb.

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<sup>16</sup> The Delaware Chancery Court ruled: "Subject to Constitutional standards of due process, Arkansas law governs the question of issue preclusion." *In re Wal-Mart Stores, Inc. Delaware Derivative Litigation*, No. 7455cB, 2016 WL 2908344 (Del. Ch. Ct., May 13, 2016). Arkansas courts had never addressed issue preclusion in the context of a stockholder derivative suit, so the court used authority from other jurisdictions to predict how a court in Arkansas would have resolved the question.

<sup>17</sup> Ironically, in 2012 Judge Hickey granted Wal-Mart's motion to stay the Western District of Arkansas litigation pending resolution of the Delaware action (with its books-and-records request), ruling that the two actions were similar. *In re Wal-Mart Stores, Inc. Shareholder Derivative Litigation*, No. 4:12-cv-4041, 2012 WL 5935340 (W.D. Ark., Nov. 27, 2012). However, Judge Hickey's ruling was overturned by the Eighth Circuit, which found that the federal securities-law allegations in the (federal court) Arkansas complaint, which were not made in the Delaware Chancery Court case, prevented a Delaware court from resolving all of the issues in the Arkansas action. *Cottrell v. Duke*, 737 F.3d 1238 (8th Cir. 2013). The stay was lifted and the action in Arkansas proceeded.

<sup>18</sup> Notice of Petition for Permission to Appeal with Eighth Circuit Court of Appeals, *City of Pontiac Employees' Retirement System v. Wal-Mart Stores, Inc.*, No. 5:12-cv-05162, (W.D. Ark., Oct. 6, 2016).

<sup>19</sup> Tim Schoenberg and Matt Robinson, "Wal-Mart Balks at Paying \$600-Million-Plus in Bribery Case," Bloomberg.com, Oct. 6, 2016.