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Recent Trends In Shareholder Derivative Litigation

Law360, New York (January 19, 2010) -- Shareholder derivative litigation has changed dramatically over the past year, with the resolution of stock options backdating litigation and the emergence of subprime mortgage-related lawsuits. These two areas of securities litigation showcase a number of trends of which counsel should be cognizant as they face a changing economic landscape.

Increased Scrutiny of Special Litigation Committees

When faced with derivative litigation, corporate boards often convene a special litigation committee ("SLC") of independent directors to consider a shareholder demand to sue or, in the case of already-pending litigation, to consider whether to move to assume control over the case from the derivative plaintiff (in which case the company could pursue some or all of the claims asserted, assert additional claims, pursue a negotiated settlement or move to dismiss the lawsuit).

Historically, SLCs have tended to exercise their business judgment to dismiss the complaint on the ground that it isn't in the company's best interests to pursue it. And more often than not, courts have accorded substantial deference to business judgment.

Thanks to stock options backdating litigation, courts are stepping up scrutiny of SLCs that seek dismissal of pending cases against insiders — especially those who are accused of having too-close ties with directors accused of wrongdoing.

In In re KLA-Tencor Corp., Shareholder Derivative Litigation,[1] for example, the U.S. District Court for the Northern District of California recently denied a motion to dismiss filed by the SLC of the KLA-Tencor Board of Directors, calling into question the size, process, and independence of the two-member SLC tasked with investigating stock options backdating allegations.

Specifically, the court took issue with the fact that an SLC member — who was charged with investigating wrongdoing associated with the company's historic stock options

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practices — was a member of the audit and the nominating and governance committees while the challenged activity occurred.

Although there wasn't any evidence of wrongdoing, the board member's previous committee service "raise[d] the possibility that [he] was tasked with investigating corporate malfeasance that he had previously, if unintentionally, approved."[2]

Additionally, the court thought that the KLA-Tencor SLC just didn't do its job effectively, as evidenced by "the lack of investigation of post-2002 backdating, the small size of the SLC and statements of counsel conflating the SLC and the company which collectively put the SLC's independence into dispute."[3]

The court also noted that "the size of the settlement that resulted from the SLC's investigation is a mere fraction of the overall damages that KLA suffered as a result of defendants' backdating activities.

That the SLC conducted an extensive overall investigation with the assistance of competent outside counsel is not enough to overcome the court's concerns with the meager size of the settlement, especially when considered in the light of the many questionable aspects of the investigation."[4]

This outcome is a potent reminder to choose the members of an SLC in such a way that the independence, good faith and due care of the SLC cannot be called in to question by the court.

Judicial Scrutiny of Settlements Has Increased

Judges have increasingly rejected non-cash derivative settlements that nonetheless provide for the payment of attorneys' fees to plaintiffs' firms.

In the Northern District of California, the court refused to approve a settlement in the In re Zoran Corporation Derivative Litigation, which would have provided for corporate reforms, the return of cancelled stock options, and $1.2 million in plaintiffs' attorneys fees — but no direct monetary compensation for the company.[5]

Instead, the court approved a settlement giving Zoran $3.4 million in cash, which was paid by Zoran's CEO, CFO and its D&O insurance.[6]

Similarly, in the Western District of Texas, Judge Sam Sparks refused to approve a settlement of the options backdating derivative lawsuit in In re Cirrus Logic Inc.[7]

After finding that the proposed reforms "appear far too meager" and the "substantial benefits" were "for the most part, cosmetic,"[8] Judge Sparks refused to approve the attorneys' fees portion of the settlement, stating that "[f]or obtaining a minimal (if not nonexistent) benefit to Cirrus, plaintiffs' attorneys under the terms of the Stipulation of Settlement would earn $2.85 million in attorney's fees for a suit that has been pending

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less than two years ... the court simply cannot fathom (and was entirely unconvinced by plaintiffs' counsel at the hearing) how counsel feels they could have earned these fees.

"Viewed objectively, the attorneys are requesting top-dollar fees for their inability to be successful in this case. By approving this Stipulation of Settlement, the court would be compensating plaintiffs' counsel handsomely and encouraging plaintiffs' attorneys in the future to go on fishing expeditions against corporations.

"Sometimes when at [sic] attorney goes fishing he catches fish, and sometimes he does not — `but when he does not he should not eat filet mignon afterwards."[9]

The parties revised the settlement to include new reforms and a $2.85 million settlement to Cirrus Logic from its D&O insurer.[10] Judge Sparks approved the new settlement,[11] which did not include a provision for attorneys' fees.[12]

In contrast, in In re Marvell Technology Group Ltd. Derivative Litigation the court did approve a non-cash settlement that would implement reforms and cancel, forfeit and reprice approximately 12.1 million stock options, which the lawyers involved valued at $54.9 million.[13]

Although the court initially expressed reservations about the amount of the fees,[14] the final judgment awarded $16 million in attorneys' fees in accordance with the stipulation filed by the parties.[15]

The court in In Re Affymetrix Derivative Litigation approved a non-cash settlement where the company adopted reforms, cancelled more that 700,000 stock options held by officers, and awarded plaintiffs' attorneys' fees of $3.5 million.[16]

The case to watch is In re Broadcom Corporation Derivative Litigation. The parties have reached a $118 million partial settlement,[17] which could lead to the second largest options backdating related derivative lawsuit settlement.[18]

It is funded entirely by Broadcom's D&O insurance and includes $43.3 million that "Broadcom had already recovered in connection with prior reimbursements from its insurers, subject to a reservation of rights that will be released upon settlement approval."[19]

The settlement contains a provision for plaintiffs' attorneys' fees in the amount of $11.5 million.[20] However, the money will not go directly to the company; rather the remainder of the settlement will go towards the $130 million in attorney fees accrued in defense of nineteen officers and directors.[21]

The question is whether the court will approve a settlement where the company is getting no monetary benefit.

Subprime-Related Claims Have Been Dismissed

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In the area of subprime derivative litigation, plaintiffs are having a difficult time bringing suits that can survive a motion to dismiss.

In Delaware, Chancellor William Chandler dismissed most of the subprime-related claims in the Delaware-based In re Citigroup Inc. Shareholder Derivative Litigation.[22]

In addition, the subprime-related derivative suit brought against Citigroup in the Southern District of New York, alleging similar claims, was also dismissed.[23]

Judge Sidney Stein held that “the complaint fails to allege with specificity facts showing that plaintiffs are excused from presuit demand,” and “does not state with particularity facts giving rise to a strong inference that the defendants acted with the required state of mind.”[24]

Shortly thereafter, Judge Stein dismissed the ERISA claims related to the subprime market, holding that defendants did not have an affirmative duty to disclose Citigroup financial information and “plaintiffs have failed to allege facts showing that the defendants knew [that any] statements were misleading.”[25]

However, claims regarding executive compensation are proceeding. In the Delaware-based Citigroup matter discussed above, Chancellor Chandler allowed claims of waste regarding executive compensation for Citigroup’s CEO to proceed, while simultaneously dismissing claims related to the subprime mortgage market.[26]

In California, a complaint was filed in March 2009 against AIG’s CEO Edward Liddy and several other AIG directors and officers alleging that Liddy’s explanation regarding bonus payments made to these executives was “outrageous on its face” and “absurd” as “there was no rational business purpose or justification for these lucrative additional payments, particularly given AIG’s deteriorating financial condition and dismal financial performance.”[27]

Damages are sought for corporate waste, breach of fiduciary duty, abuse of control and unjust enrichment.[28]

--By Jonathan A. Shapiro (pictured) and Elizabeth Rushforth, WilmerHale

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The opinions expressed are those of the authors and do not necessarily reflect the views of Portfolio Media, publisher of Law360.

[1] In re: KLA-Tencor Corp., S’holder Derivative Litig., No. 06-03445 (N.D. Cal. Dec. 12, 2009)

[2] Id. at 7.

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[3] Id.

[4] Id. at 8.

[5] In re: Zoran Corp. Derivatives Litig., No. 06-05503 (N.D. Cal. Apr. 7, 2008).

[6] In re: Zoran Corp. Derivatives Litig., No. 06-05503 (N.D. Cal. June 11, 2008).

[7] In re Cirrus Logic Inc., No. 07-00212 (W.D. Tex. Jan. 8, 2009).

[8] Id. at 12.

[9] Id. at 17.

[10] In re Cirrus Logic Inc., No. 07-00212 (W.D. Tex. Mar. 13, 2009).

[11] In re Cirrus Logic Inc., No. 07-00212 (W.D. Tex. May 28, 2009).

[12] In re Cirrus Logic Inc., No. 07-00212 (W.D. Tex. Mar. 13, 2009).

[13] In re: Marvell Technology Group Ltd. Derivative Litigation, No. 06-03894 (N.D. Cal. Aug. 11, 2009).

[14] In re: Marvell Technology Group Ltd. Derivative Litigation, No. 06-03894 (N.D. Cal. May 08, 2009).

[15] In re: Marvell Technology Group Ltd. Derivative Litigation, No. 06-03894 (N.D. Cal. Aug. 11, 2009); In re: Marvell Technology Group Ltd. Derivative Litigation, No. 06-03894 (N.D. Cal. Mar. 20, 2009).

[16] In Re Affymetrix Derivative Litigation, No. 06-05353 (N.D. Cal. June 30, 2009).

[17] In Re: Broadcom Corporation Derivative Litigation, No. 06-03252 (C.D. Cal. Aug. 28, 2009).

[18] D&O Insurers Fund $118 Million Partial Settlement of Broadcom Options Backdating Derivative Suit, available at www.dandodiary.com/2009/09/articles/options-backdating/do-insurers-fund-118-million-partial-settlement-of-broadcom-options-backdating-derivative-suit/, (Sept. 1, 2009).

[19] In Re: Broadcom Corporation Derivative Litigation, No. 06-03252 (C.D. Cal. Aug. 28, 2009).

[20] In Re: Broadcom Corporation Derivative Litigation, No. 06-03252 (C.D. Cal. Aug. 28, 2009).

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[21] Kevin LaCroix, D&O Insurers Fund $118 Million Partial Settlement of Broadcom Options Backdating Derivative Suit, available at www.dandodiary.com/2009/09/articles/options-backdating/do-insurers-fund-118-million-partial-settlement-of-broadcom-options-backdating-derivative-suit/, (Sept. 1, 2009).

[22] In re: Citigroup Inc. Shareholder Derivative Litigation, No. 3338-CC (Del. Ch. Feb. 24, 2009).

[23] In re: Citigroup Inc. Shareholder Derivative Litigation, No. 07-9841 (S.D.N.Y. Aug. 25, 2009).

[24] Id.

[25] In re: Citigroup Inc. Shareholder Derivative Litigation, No. 07-9790 (S.D.N.Y. Aug. 31, 2009).

[26] In re: Citigroup Inc. Shareholder Derivative Litigation, No. 3338-CC (Del. Ch. Feb. 24, 2009).

[27] Bible v. Liddy et al., No. BC410879 (Sup. Ct. Cal. Ct. of Los Angeles Mar. 31, 2009).

[28] Id.

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