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Rotating Mobiles and Fuzzy Boundaries: Managing Parallel Proceedings

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Introduction

Alexander Calder's "International Mobile" measures sixteen feet by sixteen feet of sheet aluminum and wire and hangs from the ceiling of The Museum of Fine Arts, Houston. Unlike most other art displays, mobiles often sway or rotate while patrons walk by. This is because mobiles are kinetic forms of art: when one portion is tugged or pushed, the entire system adjusts. This makes them beautiful to look at, and very difficult to move without careful planning.

Securities litigation is less resplendent than grand mobiles, but it can be equally interconnected and difficult to maneuver. Cases may be brought by average citizens (class actions), a prosecutorial or regulatory body (Securities and Exchange Commission enforcement proceedings or Department of Justice actions) or in the name of the corporation itself (shareholder derivative suits).

This is a complex meshwork even before we consider cases opened by state attorneys general, foreign regulators, and U.S. and international exchanges. Shareholder derivative actions alone raise issues of indemnification and fee advancement, insurance quandaries, implications of government settlements with "admissions," and questions of multiple representations.

These actions are not siloed singularities operating outside each other's existence. They often stem from a common set of facts, and each case carries its own gravity, pushing and pulling against filed or pending actions.

Parallel proceedings tend to have fuzzy boundaries. Attorneys stepping into these actions should understand how their choices in one case can filter into other matters, some of which may not yet have been filed. When one object in a mobile moves, the entire mobile readjusts. Similarly in litigation, you cannot make a decision in one case without anticipating the collateral consequences of doing so. Mobiles are delicate, and can respond dramatically when touched. Pulling on a mobile may make it more pleasing – or maybe not.

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[1] Mr. Ferrara and Ms. Ashton provided the inspiration and direction for this article, while Mr. Rogoff provided its intellectual content.

Fuzzy Boundaries in Parallel Proceedings

Boundaries separating cases appear fuzziest when it comes to shareholder derivative suits. Derivative actions relying on claims of "failure to disclose" sound more like traditional class actions. Class actions alleging breaches by company officials and SEC proceedings alleging negligent conduct by directors and officers sound more like shareholder derivative actions. Despite statements by the leaders of the SEC Division of Enforcement, it is unclear whether honest mistakes by company executives are now actionable. The barriers separating the "willful" conduct requirement for criminal securities fraud may be fast approaching the civil scienter standard.

This article will examine these shareholder derivative issues and their unclear link to other securities actions if it addresses issues such as sequencing parallel proceedings, defending or maintaining objectivity, and managing discovery.

Sequencing Parallel Proceedings

The mobile analogy applies most readily to issues of sequencing. As one action proceeds, it may "tug at the mobile" and upset the equilibrium of other actions, especially if both cases are not proceeding at the same pace.

Let's examine a relatively simple and common scenario. Based on the same operative facts, a securities class action is pending alongside a shareholder derivative action. The PSLRA provides that discovery in the class action case is stayed pending a decision on the motion to dismiss. However, the court hearing the derivative action may not be willing to link it to the securities class action, meaning the derivative action may advance in ways that affect the class action.

For example, discovery could go forward in the derivative action, even though it is subject to a PSLRA stay in the class action case. The class action plaintiffs would then argue that they are entitled to obtain such discovery. Even though the motion to dismiss is still being briefed, these plaintiffs would argue that there is no burden on the defendants in requiring such discovery when the same information must be produced to the class action plaintiffs.

Under this scenario, if the defendants prevail in their motion to dismiss and the court gives plaintiffs the right to replead, plaintiffs now have far more information at their disposal. Most courts have held that the PSLRA stay is absolute; however, some judges have ruled that class plaintiffs must be given documents that have already been produced in parallel proceedings.

This example assumes that there is a parallel derivative case, but there may be other seemingly unexpected countersuits in the fray. Imagine an ERISA class action based on the sale of the company's stock in its retirement plans exists parallel to the securities class action. ERISA discovery is not stayed by the PSLRA and it may be difficult to obtain a stay of the ERISA action. A judge may reasonably inquire why any new information produced to the ERISA plaintiffs should not be given to the class action and derivative plaintiffs as well when there is no increased burden on defendants.

Similar issues arise if a company receives a Delaware General Corporation Law Section 220 demand for documents. Once a company has compiled and delivered these documents to the shareholders, they may be equally obligated to produce documents to derivative or class action plaintiffs. Managing a securities case necessarily raises these questions, and attorneys should consider how sequencing issues can substantively impact each pending and active litigation.

Substantive Effects of Parallel Proceedings

Parallel proceedings may also substantively impact the merits of a case outside the discovery context. Parallel cases may have differing burdens of proof. Let's return to the parallel securities class action and ERISA class action example.

The ERISA plaintiffs would have to demonstrate a fiduciary breach by the plan trustees, while the securities plaintiffs would have to show that the executives acted with scienter. It is possible that the named defendants would be the same directors and executives in both cases.

If the ERISA case were to proceed to trial first and the plaintiffs were to prevail, it is unclear whether any of the findings that led to the ERISA victory would collaterally estop relitigation of the same issues in the securities case. If the securities case proceeds to trial, the scienter issue is unlikely to be subject to collateral estoppel. However, there could be findings that certain misrepresentations or omissions occurred. These findings may or may not present issue preclusion concerns in a securities class action on a material misrepresentation issue.

Defending Claims and Maintaining Objectivity

Beyond discovery and collateral estoppel, the existence of parallel actions may impact the ability to make certain arguments or pursue certain strategies. In a shareholder derivative suit, the company's directors want to maintain objectivity so as not to invoke allegations of demand futility. However, if there is a parallel securities class action pending, directors face the possibility of losing control of the potential claims to the derivative action plaintiffs.

Facing this overhanging danger, directors still may need to make substantive Rule 12(b)(6) arguments in the securities class action that they are not liable. Such an argument may suggest that the directors have already determined that the derivative plaintiffs' allegations have no substance. If true, this could lend credence to a potential futility argument from the plaintiffs.

One way of avoiding this Hobson's choice might be for the company to bear the burden of the Rule 12(b)(6) motion to dismiss the securities action, while individual director defendants limit their challenge to jurisdictional issues. Alternatively, directors in the shareholder derivative action could restrict their arguments solely to issues of demand futility while the company challenges the merits of the Rule 12(b)(6) motion.

A pending DOJ investigation could also have a significant effect on a Board's ability to conduct an objective review of shareholder allegations. Potential interviewees (perhaps to curry favor with

the DOJ) might resist speaking with a Board committee while a DOJ investigation is ongoing. This inability to speak with relevant individuals could frustrate the committee's ability to conduct a thorough and objective review.

If a review is conducted and the Board concludes that claims should be brought against certain executives, the Board's ability to pursue such claims could be hindered by an ongoing DOJ investigation. Prosecutors may be concerned about having a target become the subject of a civil proceeding that will include broad discovery of the same issues the DOJ is investigating. The DOJ may not be willing to tell the company directly not to proceed; however, the company is likely to understand the DOJ's body language broadcasting its preference that the company stand down.

Discovery

Let's return to the discovery issue. In addition to the general timing discovery issue already discussed, a company's discovery strategy might also be affected by the pendency of parallel proceedings. For example, let's posit that a company wants to voluntarily produce to the SEC. The company would want to be expansive in its production so that it can benefit from the good will associated with voluntary compliance. To do so, the company may make very tight privilege calls and create summary documents to explain these issues.

However, that position on SEC discovery may prompt plaintiffs in active securities litigation or individuals demanding document production under DGCL Section 220 to ask for all documents produced to the SEC (or any other regulatory entity). The company may be required to produce the summaries that it prepared for the SEC. Companies may be worried that these documents—combined with historical back-up documents—could provide plaintiffs with a roadmap of the company's strategy.

Overlapping Claims

Sometimes when you read the complaints in parallel cases, it is hard to distinguish one from the other. Shareholder derivative complaints rely on alleged failures to disclose—claims more associated with a securities class action. The securities class action includes allegations regarding breaches of duties owed by company officials that sound more like derivative claims. Regulatory actions also overlap, as SEC allegations speak in terms of negligent conduct by directors and officers that also sound more like shareholder derivative claims. These hybrid amalgamations of allegations may present particularly thorny issues in developing defenses.

Stein v. Blankfein

A recent Delaware Chancery Court case helpfully shows how these claims can overlap and entangle litigators if they do not tread carefully. In May 2017, a Goldman Sachs shareholder filed a complaint alleging breaches of fiduciary duty by Goldman Sachs and certain of its officials in connection with

excessive executive compensation.[2] The complaint set out four counts, two brought as direct claims of the individual plaintiff and two brought derivatively on behalf of all shareholders.

Plaintiff's direct claims were based on alleged breaches of the fiduciary duty of loyalty (including the duty of candor). These breaches allegedly arose by (*i*) failing to disclose material information relating to the shareholder approval of its stock plan[3] and (*ii*) making incomplete and misleading disclosures and omissions regarding the tax deductibility of cash-based incentive awards.[4]

On her first claim, plaintiff sought a new vote on the stock plan, rescission of all prior awards made under it, and an injunction against future grants until the stock plan was appropriately approved.[5] Regarding the second claim, plaintiff sought a shareholder vote on cash-based incentive awards with full and fair disclosures of all material information regarding the tax consequences of the awards.[6]

The derivative claims, also based on breaches of the fiduciary duty of loyalty, alleged monetary harm to the firm in connection with (*i*) excessive compensation paid to non-employee directors[7] and (*ii*) the issuance of invalid stock-based awards made under the stock plan (which was allegedly void because of the failures to disclose material information to shareholders in connection with its approval).[8] Regarding these claims, plaintiff sought "an accounting, disgorgement, rescission and/or the recovery of recessionary damages" from the directors, among other remedies as well.[9]

In March 2018, plaintiff and the defendants reached a settlement concluding both the derivative and direct claims.[10] Because it was resolving the derivative claims on behalf of all shareholders, the settlement was presented to the court for approval. The settlement relief consisted of additional disclosure in Goldman's 2018 proxy statement on the relevant compensation issues and certain other governance provisions relating to a review of compensation practices.[11]

At the approval hearing, Vice Chancellor Glasscock III expressed confusion with the proposed terms, stating that the deal did not seem balanced given that board members were not surrendering the stock options at the core of the derivative allegations.[12] Furthermore, the director defendants were supporting a settlement of direct claims that would void the derivative claims—which were assets of the company.

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2 Verified Stockholder's Complaint, *Stein v. Blankfein et al.*, No. 17-9354 (Del. Ch. May 9, 2017).
3 ¶¶ 56-61.
4 ¶¶ 67-71.
5 ¶ 61.
6 ¶ 71.
7 ¶¶ 51-55.
8 ¶¶ 62-66.
9 ¶ 55, 66.
10 Stipulation and Agreement of Compromise, Settlement, and Release, Stein v. Blankfein et al., No. 17-0354 (Del. Ch. Mar. 20, 2018).
11 *Id.*
12 Sullivan, Vince, "Chancery Judge Says Goldman Settlement Makes No Sense," Law360 (Sept. 21, 2018, 5:48 PM EDT), https://www.law360.com/articles/1085266/chancery-judge-says-goldman-settlement-makes-no-sense.

The only shareholder who objected to this settlement was Sean Griffith, a professor at the Fordham University School of Law. He argued that this arrangement drifted afoul of Trulia[13] because it fell under the scope of "disclosure-only" settlements.[14]

With no clear solution to his confusion, Vice Chancellor Glasscock III denied approval of the settlement. Noting the "unique concerns"[15] raised by a case in which the plaintiff stockholder brought direct as well as derivative claims, Vice Chancellor Glasscock described the action as "restat[ing] claims of violations of securities law as state disclosure claims brought directly on behalf of a stockholder, and tack[ing] on derivative claims against directors for conflicted and improper awards to themselves and employees."[16]

The Vice Chancellor pointed out that the director defendants were supporting a settlement that voided derivative claims against them (which were assets of the company) by agreeing that the company would take or maintain "future acts of corporate hygiene."[17] The court found that the direct disclosure claims might have merit, but were "unrelated to the damages/disgorgement claims for conflicted overpayment that are the heart of the derivative claims."[18]

The court concluded that it could not find a settlement to be reasonable that "effectively resolves direct claims belonging to the Plaintiff in return for voiding potentially-meritorious monetary causes of action belonging to the Company."[19] Because the objector was "helpful," the court held that he should be awarded attorney fees while the plaintiff's request for fees was denied without prejudice.[20] The court then directed the parties to consult with the objector on an appropriate award and inform the court whether further action was required.

Representation Issues

Whenever a series of parallel actions are pending, questions of representations arise including who reports to whom and who represents whom. In a derivative action, it is important to distinguish between "company" counsel and "director review committee" counsel. Counsel assisting the committee should be retained by the company for privilege issues, but should report exclusively to the committee. This protects privileged communications between company counsel and committee counsel. Neglecting this protection is one of the biggest mistakes made by counsel for special committees considering derivative demands and claims.

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[13] *In re Trulia, Inc. Stockholder Litig.*, 129 A.3d 884, 887 (Del. Ch. 2016) (limiting disclosure-only settlements to narrow circumstances and restricting broad litigation releases in settlements).
[14] Sullivan, *supra* note 12.
[15] Letter Opinion and Order, *Stein v. Blankfein et al.*, No. 17-0354 (Oct. 23, 2018) at 10.
[16] *Id.* at 11.
[17] *Id.*
[18] *Id.*
[19] *Id.* at 12.
[20] *Id.*

Representation issues also arise regarding the individual defendants in the different actions. This should be considered the "who represents whom" leg of the analysis. There are definite benefits in consolidating representation of all non-conflicted individuals with the counsel representing the company. It tends to be more cost-efficient and strategy-friendly, in that it prevents defense of the case from being unnecessarily balkanized.

However, such representation must be properly set up and appropriately managed. The engagement letter must be clear: if a conflict between an individual and the company arises, counsel will be able to continue to represent the company while the individual will have to seek other representation. The individual will have no means to disqualify company counsel from continuing to represent the company.

In appropriate situations, the company should consider the use of shadow counsel. This can operate as a back-up for individuals if a conflict arises. Even if no conflict arises, shadow counsel allows an individual to seek advice from counsel that is not also representing the company.

If a criminal or regulatory investigation is pending, there may be objections from the government entity to company counsel representing some or all individuals. This may doom any attempt at joint representation, but the company and its counsel should still attempt to keep expenses and balkanization down, including by offering pool counsel who will work closely with company counsel to all non-conflicted individuals.

Directors and Officer Insurance Issues

One last topic to consider through the mobile analogy is the effect of different actions on director and officer insurance issues. Difficult questions can arise regarding "prior related acts" when an earlier case is noticed that at some future time touches upon a later filed class action or shareholder derivative action. This is particularly true when the alleged conduct is not a single act, but rather a series of acts or omissions that continue over an extended period.

For example, if the securities class action is based on misrepresentation or omissions regarding foreign bribery, it is possible that the bribery case will have been filed sometime before the securities case. The insurance company might take the position that the later filed securities case related back to the bribery case. It would therefore be under the policy in place at the time the bribery case was filed, as opposed to the policy in place at the time the securities complaint was filed. Several issues may follow from such a determination – including that the earlier policy may be depleted in part or in full by other matters or that the face value of the earlier policy may be less than the current policy.

There are also issues arising out of allocation of policy limits among insureds. Side A coverage may protect directors from such results. However, not all companies provide Side A coverage – or enough of it. In a situation where there is no Side A coverage, all insureds look to the ABC policy but many of the policies have no allocation provisions among insureds – it is more or less a first-filed claim payment schedule. If there is no Side A policy for individuals, the individuals might want to preserve

policy proceeds for their own use in connection with SEC or DOJ investigations while the company might wish to use the proceeds to defend or settle a class action against the company. There may be issues regarding who has the first chance to act on these policy limits: the company or the directors.

Conclusion

Attorneys should remember that litigation is rarely simple, with one plaintiff alleging one claim against one securities-related defendant. A single shareholder derivative action could lead to myriad related cases. This means each action must be managed with an eye towards parallel proceedings.

When faced with these issues, remember the Alexander Calder mobile. If you pull on one plate, the entire array shifts. It may make the sculpture better or worse, but you better understand that before you make your move.