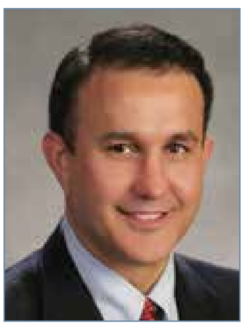
Chancery Confirms That Derivative Litigation Is an Asset of the Corporation

By Francis G. X. Pileggi



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On May 7, 2015, Park Employees' and Retirement Board Employees' Annuity and Benefit Fund of Chicago filed a derivative shareholder suit against the pharmaceutical company BioScrip. The plaintiff, a stockholder since January 2012, alleged that BioScrip engaged in corporate misconduct, which included kickback schemes, insider trading, and the concealment of the declining profitability of one of its business segments. Instead of pressing the board to pursue litigation, the plaintiff pleaded "demand futility," meaning the plaintiff believed that it was useless to demand that the board pursue a claim, in this case because it lacked independence. Per the terms of its proxy statement, BioScrip held its annual elections on May 11. By the end of the day, the company had near-complete turnover of its board: of the seven directors, only two who were named in the suit remained. That same day, the suit was formally delivered to the company.

Which iteration of BioScrip's board was responsible for pursuing a claim against the company: the board as it existed on May 7, when the claim was filed in court, or May 11, when the claim was delivered to the company? This question was at the heart of the case that unfolded this spring in the Delaware Court of Chancery.

Under Delaware corporate law, directors control corporate assets, and derivative litigation is considered a corporate asset. The general rule is that the board in place at the time the complaint is filed is the board that controls the litigation asset. The twist here is the degree of board turnover in the two business days after the suit was filed.

There is, however, an exception to this general rule that allows a stockholder to bring a suit, or "demand," on behalf of the corporation. This is referred to as a demand excusal. A prerequisite for this, however, is that the stockholder must demonstrate why the majority of the board is compromised in their ability to exercise their business judgment. If that requirement cannot be met, the stockholder must first present its demand to the board, explaining why the board should pursue the claim on behalf of the corporation.

But this exception only applies when a stockholder moves to have the board pursue litigation against the company and that demand is wrongfully refused or if there is reason to think that making the demand would have been futile. This ensures that important business decisions, such as whether to litigate or not, are made by the board and not stockholders. In this case, the majority of the new board was comprised of non-defendant directors and was thus largely independent of the directors named in the suit. Further, the May 11 board was the only board that would have been in a position to fairly evaluate the plaintiff's complaint when it was originally filed. The court consequently dismissed the suit against BioScrip's board.

The court recognized that by holding the May 11 board to the standards of demand futility that there is an opportunity for companies to game the system through timely alterations of their board's composition. But the court expressed confidence that it was fully capable of sniffing out any improper manipulations. The court explained that the fear of gamesmanship did not justify the notion that only the May 7 board should evaluate a shareholder demand.

The court also highlighted that its ruling did not disturb the general rule that demand futility should be assessed as of the date a complaint is filed. Rather, due to the unique facts presented in this case, the court found that a departure from that general rule was both equitable and in keeping with the policy concerns that applied.