

## Staying Shareholder Derivative Suits in Favor of Related Securities Class Actions

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Often, when a shareholder class action is filed against a corporation and its officers and directors, alleging that the shareholders suffered financial losses because of violations of the federal securities laws, a shareholder derivative suit will soon follow. In contrast to the shareholder class action, which seeks money for the shareholders, a shareholder derivative suit seeks money for the corporation itself. Usually, the shareholder derivative suit is lodged against the corporation's officers and directors, on grounds that they allegedly breached their fiduciary duties to the corporation by allowing the securities violations to occur and thereby exposed the corporation to liability in the shareholder class action. The defendants in the class action and the derivative suit frequently are the same, which means that they face both sets of litigation concurrently.

The confluence of these two distinct sets of lawsuits presents practical difficulties. For example, the amount of damages exposure at issue in the derivative suit is usually contingent on the outcome of the class action. Thus, it is often difficult, if not impossible, to gauge the potential scope of damages in the derivative suit before the class action is decided. In addition, securities class actions typically are brought under section 10(b) of the Securities Exchange Act of 1934, and such actions are subject to an automatic stay of discovery pursuant to the Private Securities Litigation Reform Act (PSLRA) while a motion to dismiss is pending. Derivative suits for breach of fiduciary duty, however, typically are not subject to the PSLRA's automatic discovery stay, yet permitting the derivative suit to proceed would undermine the stay's effect in the class action. Moreover, the interests of the corporation—as defendant in the class action but the purported beneficiary in the shareholder derivative suit—are in conflict in the two sets of litigation, with the corporation likely vigorously defending the class action and denying that any securities violations occurred, at the same time its shareholder is contending that the officers and directors are liable to the corporation for causing the

alleged violations. Further, defending class actions and derivative suits simultaneously can place enormous burdens on the defendants, straining legal resources.

For these reasons, defendants facing dueling class and derivative lawsuits often request that the derivative suit be stayed pending resolution of the class action. Plaintiffs' derivative counsel, on the other hand, usually want to press forward with prosecution of the derivative suit, to achieve results and ultimately to be in a position to make a petition for attorney fees. This article discusses the approaches that courts have taken in adjudicating these competing interests and determining whether to grant a stay.

### Factors Considered by Federal Courts

Several federal courts have addressed the propriety of staying derivative suits pending related securities class actions. Their approaches illuminate the factors that courts consider in deciding this issue.

In *Breault v. Folino*, No. SACV10826GLTANX, 2002 WL 31974381 (C.D. Cal. Mar. 15, 2002), shareholder plaintiffs brought a derivative lawsuit on behalf of Emulex Corporation against certain of the corporation's directors and officers, contending that the defendants breached their fiduciary duties by engaging in insider trading and issuing false statements. At the same time, several class actions were pending against Emulex for similar claims. *Id.* at \*1. The defendants moved to stay the derivative suit pending resolution of the class actions, and the court granted the motion. In reaching its decision, the court reasoned that simultaneous prosecution of both the derivative and class litigation would not be in Emulex's best interests. Specifically, the court noted that although Emulex was likely to rely on the defendants as witnesses in the class actions, the plaintiffs would "need to undermine [d]efendants' credibility to pursue [the

derivative suit].” The court also reasoned that moving forward with the derivative suit would divert the company’s “financial and management resources” from the pending class actions. *Id.* at \*2. The court considered imposing an “ethical wall” to prevent potential discovery in the derivative suit from reaching the class action plaintiffs but decided that such an ethical wall could not be implemented in a practical way. *Id.* at \*2 n.2.

Similarly, in *Cucci v. Edwards*, No. SACV 07-532 PSG (MLGx), 2007 WL 3396234 (C.D. Cal. Oct. 31, 2007), a shareholder of Powerwave Technologies, Inc., asserted derivative claims against certain officers and directors of the company, alleging that the defendants artificially inflated Powerwave’s stock by making false and misleading statements. A securities class action asserting similar allegations was concurrently pending before the same court. The defendants moved to stay the derivative suit pending resolution of motions to dismiss in the securities class action, and the court granted the motion. *Id.* at \*1. The court reasoned that because both the derivative and class action litigation called for “the determination of the same or substantially related questions of fact,” judicial economy would be served by temporarily staying the derivative suit. The court further explained that “[a]t this early stage of the litigation, it seems sensible . . . for Powerwave to devote its resources at this time exclusively to the [class action].” *Id.* at \*2. The court also noted that the derivative plaintiff did not oppose the stay at issue and that there was no evidence that a stay would prejudice the plaintiff or that a “pressing need” existed for simultaneous prosecution of both lawsuits. *Id.*

Several other federal courts addressing this issue have considered similar factors. *See, e.g., In re Ormat Techs., Inc. Derivative Litig.*, No. 3:10-cv-00177-ECR-RAM, 2011 WL 3841089, at \*4–5 (D. Nev. Aug. 29, 2011); *Lloyd v. Carney*, No. 11-1386 (SRC), 2001 U.S. Dist. LEXIS 86647, at \*4 (D.N.J. Aug. 5, 2011); *Rosenblum v. Sharer*, No. CV 07-6140 PSG (PLAx), 2008 U.S. Dist. LEXIS 65353, at \*24 (C.D. Cal. July 28, 2008).

In some cases, federal courts have determined that it is appropriate for derivative suits to proceed simultaneously with related securities class actions. For example, in *Sonkin v. Barker*, 670 F. Supp. 249 (S.D. Ind. 1987), shareholders of Public Service Company of Indiana filed derivative suits against present and former officers and directors of the corporation. The plaintiffs alleged that the defendants breached their fiduciary duties through their mismanagement of a nuclear power facility construction project, and the plaintiffs sought direct and indirect damages associated with the abandoned project. *Id.* at 250. The defendants moved to stay the derivative suit in favor of a pending securities class action

and a regulatory proceeding that stemmed from similar underlying facts. *Id.* at 253–54. The court denied the motion, explaining that the derivative suit “allege[d] damages to [the corporation] beyond those attributable to [the securities class action]” and that the corporation “ha[d] already incurred a loss estimated at 2.7 billion dollars” as the result of a settled regulatory action. *Id.* at 252–53. The court further noted that it had already consolidated discovery between the derivative suit and the securities class action, and stated that a stay would “run contrary to the objective of an orderly, coordinated progression of discovery” in the cases. *Id.* at 253.

Other federal courts have similarly allowed related derivative suits and securities class actions to progress concurrently in certain circumstances. *See, e.g., In re Heelys Inc. Derivative Litig.*, 3:07-cv-01682-K (N.D. Tex. Aug. 14, 2008) (denying motion to stay federal derivative suit in favor of federal securities class action).

## Factors Considered by the Court of Chancery of Delaware

Because Delaware serves as the state of incorporation for many United States corporations, the Court of Chancery of Delaware frequently addresses the issue of whether to stay derivative suits pending related securities class actions.

For example, in *Brudno v. Wise*, No. Civ.A. 19953, 2003 WL 1874750 (Del. Ch. Apr. 1, 2003), a shareholder of El Paso Corporation brought a derivative suit in the Court of Chancery of Delaware against the company’s directors, alleging, among other things, that the defendants breached their fiduciary duties by violating federal securities laws. *Id.* at \*1. Several securities class actions had already been filed against El Paso and certain company insiders in federal court in the Southern District of Texas. *Id.* at \*2. The defendants moved for a stay of the derivative suit, and the Court of Chancery of Delaware granted the motion. Vice Chancellor Strine reasoned that “[g]iven that the overwhelming thrust of the Delaware Action complaint is a demand for indemnification largely for harm to be incurred by El Paso in the Federal Securities Action, the sensible ordering of events is for the Federal Securities Action to proceed first.” *Id.* at \*5. The court also noted that the federal judge handling the securities class action had already stayed a related federal derivative suit that was filed in her court and that it would be therefore “in keeping with principles of comity” to stay the Delaware derivative suit. *Id.* at \*1. The court also cautioned that it was staying the derivative suit only “for the time being” (emphasis in original) and that “[i]t

may be that at some point in time there would be utility to having either the Federal Derivative Action or this [Delaware derivative suit] proceed in some way at the same time as the Federal Securities Action.” *Id.* at \*5.

Recently, in *Brenner v. Albrecht*, C.A. No. 6514-VCP, 2012 WL 252286 (Del. Ch. Jan. 27, 2012), a shareholder of SunPower Corporation brought a derivative suit against certain directors and officers of the company for alleged breaches of fiduciary duty related to the company’s restatement of its 2008 and 2009 financial statements. Among other things, the plaintiff sought indemnification for whatever damages the company might incur in a related consolidated federal securities class action stemming from the same alleged financial misstatements. *Id.* at \*1. The defendants moved to stay the derivative suit, and the Court of Chancery of Delaware granted the motion. In reaching its decision, the court considered whether the practical considerations identified by the defendants outweighed the prejudice the plaintiff would suffer if a stay was issued. *Id.* at \*4. The court noted that “[p]rosecution of [the plaintiff’s] derivative action would involve taking actions designed to refute the merits of the Company’s defense of the Securities Class Action, and vice versa” and that a stay would minimize the risk of prejudice to SunPower. *Id.* at \*6. The court also explained that although the relief sought by the plaintiff was

“only partially contingent on the outcome of the Securities Class Action, ‘it is difficult to fault the idea that the primary liability case . . . should go forward before the [derivative] case seeking indemnity, when the indemnity case’s outcome necessarily depends on the outcome of the [Securities Class Action].’” *Id.* (quoting *Brudno*, 2003 WL 1874750, at \*4). The court acknowledged that a portion of the plaintiff’s claims was then ripe for adjudication but explained that “prejudgment interest can redress any harm caused by a delay.” *Id.* at \*7. The court also emphasized that it was willing to “reconsider the propriety of a stay from time to time” and that it would “redress promptly any excessive and unexpected burden that such a stay ultimately might cause.” *Id.*

## Conclusion

When confronted with the practical difficulties of having shareholder class actions and derivative suits proceed concurrently, courts focus on several different factors in determining whether to stay derivative suits pending related securities class actions. Securities lawyers should be mindful of these factors and consider how they relate to the particular circumstances of their cases when deciding whether and how to move for or oppose a stay.