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A Blueprint For Defending Derivative Actions

By Jeffrey W. Kramer

Shareholder derivative actions afford shareholders an important vehicle for redressing corporate wrongdoing by company insiders. They may also be used as strike suits by professional plaintiffs and others who hope to create leverage for settlements through expensive and time-consuming litigation and discovery. A recent opinion by the California Court of Appeal provides a blueprint for the successful defense of derivative actions and is likely to be used as a model by corporate defendants and California courts alike to resolve many derivative actions at the pleading stage, without any discovery. The case is *Bezirdjian v. O'Reilly*, 2010 DJDAR 4724, decided March 30, 2010.

Lawrence Bezirdjian filed a shareholder derivative action against current and former members of the Board of Directors of Chevron Corp., alleging breaches of fiduciary duty, gross mismanagement, constructive fraud and waste of corporate assets in connection with illicit payments Chevron allegedly made to Saddam Hussein in exchange for Iraqi oil from 2000 to 2003. The allegations of the complaint were based on an article published in May 2007 in the *New York Times*. The article reported that Chevron was negotiating a settlement with U.S. prosecutors in which the company would admit it should have known illegal kickbacks were being paid to Saddam Hussein and would agree to pay fines totaling $25 million to $30 million. Bezirdjian alleged that Chevron's board either approved or recklessly failed to prevent this conduct, and was liable to the company for the fines and other damages caused by this breach of their fiduciary duty.

In *Bezirdjian*, Chevron never defended the alleged payments to Saddam Hussein or the alleged breaches of fiduciary by its board. To the contrary, Chevron sought dismissal of the case by filing a motion for judgment on the pleadings, essentially asking the court to assume the truth of those allegations. Yet Chevron prevailed on its motion, obtained an order dismissing the case, and did so without ever having to provide the plaintiff with any discovery.

Chevron's successful defense involved four key steps. First, Chevron's board formed a litigation committee composed of three directors who were not on the board when the alleged payments to Saddam Hussein were made, and charged them with the task of investigating the plaintiff's allegations. Second, Chevron's board passed a resolution that the conclusions of its litigation committee would be binding on the Board without further review. Third, Chevron obtained a stay of the litigation to permit the committee to perform its investigation. Fourth, when the litigation committee decided against pursuing the litigation, Chevron moved for judgment in its favor solely on the basis of the committee's conclusion, as reported to the plaintiff in a letter from Chevron's attorney. The letter stated that the committee and its counsel interviewed 34 individuals, reviewed over 150,000 pages of documents, and "determined it not to be in the best interests of Chevron or its stockholders to pursue the claims asserted" in the complaint. The letter did not disclose the committee's reasoning, nor even indicate whether the committee produced any written report.

In dismissing the plaintiffs' claims, the court relied on the business judgment rule, which is generally the principle that courts under certain circumstances should defer to the business decisions of corporate directors. Applying Delaware law because Chevron is a Delaware corporation, the court noted that directors, rather than shareholders, manage the affairs of a corporation, including decisions about whether the corporation should file a lawsuit. The business judgment rule creates a presumption that a board of directors, in making decisions not involving self-interest, acts on an informed basis, in good faith and in the honest belief that its decisions are in the corporation's best interests. Chevron was not required to prove conclusively by a preponderance of the evidence that the committee, acting for Chevron's board, was independent or had acted diligently or in good faith, but merely was required to allege facts to raise these presumptions. The burden then shifted to the plaintiff to allege facts sufficient to rebut these presumptions. The plaintiff could not meet this burden, perhaps in part because the court rejected plaintiffs request to conduct discovery.

The business judgment rule, when skillfully employed, is a formidable weapon against derivative lawsuits.

The key to Chevron's victory, and the lynchpin of the court's ruling, was the board's appointment of a committee consisting of directors who were not members of the board during the time of the allegedly wrongful conduct. These facts were sufficient for Chevron to meet its initial burden of alleging facts to establish that the board, acting through the committee, had no self-interest, thereby triggering the usual presumptions of the business judgment rule.

Chevron avoided having to submit to discovery in two ways. First, the

company made no response to the central allegations of the complaint — its allegedly illicit payments to Saddam Hussein and whether the Board knew about them. This avoided creating any factual issue that could support a demand for discovery. Second, Chevron sought dismissal by means of a motion for judgment on the pleadings, relying on the allegations of the complaint, facts subject to judicial notice, and facts to which plaintiff had stipulated. By using this procedure, rather than a motion for summary judgment, Chevron kept the focus on the sufficiency of the plaintiff's allegations and away from the existence of disputed facts that might have opened the door to discovery.

In refusing the plaintiff the right to take discovery, the court found that plaintiffs are not entitled to develop facts to meet the requisite pleading standard by conducting discovery into whether a board's actions are disinterested, diligent or in good faith, but instead must obtain this information before filing suit by using the "tools at hand." This is a reference to books-and-records discovery generally available to shareholders under state law and available under California law under Corporations Code Section 1601. The court rejected the plaintiff's argument that Section 1601 authorizes discovery into corporate records in an ongoing lawsuit.

Nor is it likely that even limited discovery would have would have enabled the plaintiff to meet his burden of rebutting the presumption of the business judgment rule as applied to the committee's conclusion. Because the committee consisted of three directors who were not on the board at the time of the alleged wrongdoing, their lack of self-interest in the outcome of the investigation appears unassailable. The plaintiff had no facts to allege with particularity that the committee did not act independently or that its recommendation to the board was wrongful.

As this case demonstrates, the business judgment rule, when skillfully employed, is a formidable weapon against derivative lawsuits. The *Bezirdjian* opinion provides a primer on the applicable Delaware law and a clear rationale for the denial of discovery unless the heightened pleading standards for derivative actions are met. It is likely to figure prominently in the future litigation of California derivative actions as well.

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