

What Act 170 Means For Shareholder Litigation In Pa.

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Law360, New York (April 25, 2017, 2:17 PM EDT) -- Signed into law in November 2016, Pennsylvania's Act 170 became effective as to all Pennsylvania corporations at the beginning of this month. Among Act 170's most important provisions are changes and clarifications to the initiation and conduct of shareholder derivative lawsuits in Pennsylvania.

Before Act 170, Pennsylvania statutory law provided little guidance as to suits filed by shareholders derivatively on behalf of the corporation. Two decades ago, in *Cuker v. Mikalauskas*, the Pennsylvania Supreme Court attempted to fill in the gaps left by the statutory corporate law.[1] In *Cuker*, the court adopted the American Law Institute's Principles of Corporate Governance and provided that a board's decision "regarding litigation by or on behalf of a corporation, including shareholder derivative actions, are business decisions as much as any other financial decisions" and therefore "are within the province of the board of directors." [2] *Cuker* required shareholders to serve a demand on the corporation before filing suit and stated that where a corporation's board of directors forms a special litigation committee (SLC) to investigate the claims made in a demand, Pennsylvania courts will not second-guess the corporation's decisions if the members of the SLC are independent and disinterested, if the SLC was assisted by counsel, prepared a report and conducted an adequate investigation, and if the SLC's determination on the demand is made in good faith.[3]

Act 170 makes clear that *Cuker* remains good law in Pennsylvania, codifies certain requirements set forth by the Pennsylvania Supreme Court in that case, and adds new requirements. Pennsylvania corporations should not overlook Act 170's important provisions concerning shareholder litigation, which differ from Delaware's standards and procedures governing shareholder derivative litigation in several important respects.

Requirements for Shareholders Pursuing Derivative Claims



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Act 170 requires shareholders seeking to vindicate a corporation's rights to make a pre-suit demand on the corporation's board of directors before filing a derivative action.[4] Demand will be excused only in rare cases where the shareholder-plaintiff can show that irreparable harm to the corporation would result if demand were required, and in such cases, the demand still must be made promptly after commencing an action.[5] The shareholder's demand to the corporation must give reasonable specificity of the essential facts relied upon to support each claim made.[6] Notably, Act 170's universal demand requirement rejects the law developed in Delaware and other states excusing pre-suit demand if the shareholder adequately alleges that demand would be futile.[7]

Once a derivative action is pending, a shareholder must make a new demand to the board of directors if he wishes to bring a new claim not fairly subsumed under the original demand to the corporation.[8] Importantly for both the shareholder and the corporation, the claims made in the new demand will not relate back to the date of the original demand for purposes of the statute of limitations.[9]

Act 170 also imposes a security requirement on certain shareholder-plaintiffs. Specifically, if an action is instituted or maintained by holders of less than 5 percent of the outstanding shares of any class of the corporation, unless those shares have an aggregate fair value in excess of \$200,000, the corporation can require the plaintiffs to give security for the reasonable expenses, including attorneys' fees, that the corporation may incur as a result of the litigation.[10] The security requirement may be waived only if a court finds after an evidentiary hearing that undue hardship on plaintiffs and serious injustice would result.[11] This security requirement differs from the practice in Delaware and many other states.

Procedures for Corporations Facing Shareholder Demand or Action

Act 170 also clarifies the procedures available to corporations facing a shareholder demand or action. Specifically, the statute provides that a corporation may form an SLC to investigate the shareholder's claims.[12] If the board of directors appoints an SLC and a shareholder commences an action before the SLC makes its determination regarding the demand, the statute provides that (1) the time for defendants to plead is tolled, and (2) the court, on a motion by the SLC, shall stay discovery for the time reasonably necessary to permit the SLC to complete its investigation, except for good cause shown. If an SLC is not appointed and the corporation does not bring an action within a reasonable time after receiving a demand, then the shareholder may proceed with the action.[14] Accordingly, corporations wishing to control the decision whether or not to bring claims have a strong incentive to form an SLC to investigate.

Under Act 170, the SLC should be appointed by a majority of the directors not named as actual or potential defendants in the demand.[15] Where all directors might be considered actual or potential defendants, the SLC should be appointed by the majority of the directors.[16] The SLC must be comprised of at least two members[17] and may be given authority to act on behalf of the corporation without any further action by the board of directors.[18] As explained in the committee comments to Act 170, the SLC "is intended to function as a surrogate decision-maker" for the corporation.[19] Pursuant to Act 170, SLC members must be disinterested in the claims asserted in the demand, capable as a group of objective judgment under the circumstances, and may, but need not be, shareholders or

directors of the corporation.[20] Once the SLC has been formed, the corporation must send notice to the shareholder making the demand, informing the shareholder that a SLC has been formed and providing the names of the SLC members.[21]

After an SLC conducts an appropriate investigation, the SLC or the board of directors may determine that it is in the best interest of the corporation to take one of many potential actions, including, among other things, determining that (1) no action should be brought; (2) an action already commenced be dismissed; (3) claims be settled; (4) claims be brought by the corporation; and (5) the party making a demand be permitted to continue an action or bring claims.[22]

Standards for Pennsylvania Courts Reviewing Shareholder Derivative Actions

Act 170 also codifies the standard of review a court must apply in a shareholder derivative lawsuit where an SLC was appointed and made a determination. Where the corporation elects to file a motion to dismiss the shareholder litigation brought relating to a shareholder demand evaluated by a SLC, the corporation will be required to file with the court a statement of the SLC's determination and the SLC's written report supporting the determination.[23] The shareholder also must receive a copy of the report, but the corporation may move to file the report under seal and subject the report to a protective order, if appropriate.[24]

In ruling on a corporation's motion to dismiss, courts may consider only whether the SLC members meet the required qualifications and whether the SLC conducted its investigation and made its recommendations in good faith, independently and with reasonable care. The standard for judicial review under Act 170 differs significantly from that under Delaware corporate law, which requires a court to apply its own business judgment when evaluating a corporation's decision to terminate shareholder litigation.[26] In Pennsylvania, if the court finds that the statutory standards for an SLC and its investigation are satisfied, the court must enforce the SLC's determination regarding the shareholder demand. Accordingly, if a properly constituted SLC exercising reasonable care determines, in good faith, that an action should not be brought on the claims in the demand, the court should dismiss the shareholder's lawsuit.

Conclusion

Act 170 has a significant impact on shareholder derivative litigation for corporations in Pennsylvania. The provisions of Act 170 are more demanding of shareholders and deferential to the properly considered determinations of the corporation. The act's universal demand requirement leaves shareholders with no "futility" escape to making a demand on the corporation. Coupled with the requirement that smaller shareholders post security to cover the costs incurred by the corporation in the shareholder litigation, Act 170 will likely chill some frivolous shareholder litigation. For shareholder demands that are investigated by an SLC formed by the corporation, courts in Pennsylvania will not second-guess the SLC's determinations, instead only inquiring into the disinterested and independent nature of the SLC and the care taken in the SLC's investigation. Given Pennsylvania's unique statutory

procedures and standards, it is important that Pennsylvania corporations select counsel with knowledge of Pennsylvania corporate law when faced with a shareholder demand or action.

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[1] 692 A.2d 1042 (Pa. 1997).

[2] *Id.* at 1048.

[3] *Id.*

[4] 15 Pa. C.S.A. § 1781(a)(1).

[5] 15 Pa. C.S.A. § 1781(b).

[6] 15 Pa. C.S.A. § 1781(c).

[7] 15 Pa. C.S.A. § 1781 committee comment — 2016.

[8] 15 Pa. C.S.A. § 1781(d).

[9] *Id.*

[10] 15 Pa. C.S.A. § 1782(c).

[11] *Id.*

[12] 15 Pa. C.S.A. § 1783.

[13] 15 Pa. C.S.A. § 1783(b).

[14] 15 Pa. C.S.A. § 1781(a)(1)(i).

[15] 15 Pa. C.S.A. § 1783(d)(1).

[16] 15 Pa. C.S.A. § 1783(d)(2).

[17] 15 Pa. C.S.A. § 1783(c).

[18] 15 Pa. C.S.A. §1783 committee comment — 2016.

[19] Id.

[20] 15 Pa. C.S.A. §1783(c).

[21] 15 Pa. C.S.A. § 1783(a).

[22] 15 Pa. C.S.A. § 1783(e).

[23] 15 Pa. C.S.A. § 1783(f)(1).

[24] Id.

[25] 15 Pa. C.S.A. §1783(f)(3).

[26] 15 Pa. C.S.A. § 1783 committee comment — 2016 (rejecting approach in *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981), and favoring approach in *Auerbach v. Bennett*, 393 N.E.2d 994 (N.Y. 1979)).