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Shareholder Derivative Action Settlement Negotiation Checklist

by Practical Law Commercial Litigation

Status: **Maintained** | Jurisdiction: **Delaware, USA (National/Federal)**

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A Checklist of key issues to consider when pursuing and negotiating a settlement in a shareholder derivative action. This Checklist provides guidance for plaintiffs' and defendants' counsel on when the parties should consider settlement, who should take part in those discussions, and how to include director and officer insurers. It also identifies the essential terms that parties should discuss during settlement negotiations.

Understand the Legal Framework for Settling Shareholder Derivative Actions Pending in Federal Court

- Understand that Federal Rule of Civil Procedure (FRCP) 23.1 requires the court, after a hearing, to approve a proposed settlement if it is fair, reasonable, and adequate, after considering whether:
  - the named plaintiffs and counsel have adequately represented the shareholders, and the benefits achieved by the settlement are reasonable in light of the potential recovery at trial;
  - the proposal was negotiated at arm's length;
  - the settlement is adequate considering the costs and uncertainty of a trial, the effectiveness of proposed governance reforms or distributing payment to the shareholders, attorneys' fees, and any agreement made between the parties in connection with the proposed settlement; and
  - the presence of any shareholder objections weighs for, or against, approval.

  (For example, *Lanham on behalf of Lightning eMotors, Inc. v. Katz*, 2024 WL 1719454, at *2-3 (D. Colo. Apr. 22, 2024).)

Understand the Legal Framework for Settling Shareholder Derivative Actions Pending in the Delaware Court of Chancery

- Understand that Delaware Court of Chancery Rule (Del. Ch. Ct. R.) 23.1 requires the court, after a hearing, to approve a proposed settlement if it is fair, reasonable, and adequate, after considering whether:
  - the named plaintiffs and plaintiffs' counsel adequately represented the entity;
  - adequate notice of the hearing was provided;
  - the parties negotiated the settlement at arm's length; and
  - the settlement relief falls within the range of reasonable results by weighing the strength of the claims, the delay, expense, and risks of litigation, the scope of the release, and any objections to the settlement.

  (Del. Ch. Ct. R. 23.1(d)(5).)
- If the action is pending in a different state court, review the rules of civil procedure that govern shareholder derivative actions in that forum.

Defense Counsel Strategize About When to Begin Settlement Discussions

- Determine the optimal time to begin settlement discussions, which typically hinges on the status of any pending motions to dismiss.
- Consider beginning negotiations after the court rules on a motion to dismiss the shareholder derivative action because:
  - the stringent pleading standards for the demand allegations in shareholder derivative complaints result in higher dismissal rates than for most other types of cases (see Practice Note, Pre-Suit Demand Pleading Procedure in a Shareholder Derivative Action: Heightened Pleading Standard); and
  - discovery in a shareholder derivative action usually does not begin until the resolution of the motion to dismiss (see Practice Note, Shareholder Derivative Litigation: Overview: Discovery Stays).
- Consider negotiating before the court decides any motion to dismiss. Though less common, this approach suits cases with:
  - unusual sets of facts suggesting to defendants that the plaintiffs' case may get stronger over time; or
  - defendants who prioritize resolving the litigation because of business or financial factors.
- Determine how to proceed if the court denies a motion to dismiss in whole or in part. In this instance, defense counsel generally explore other times to settle, including:
  - right after the court decides the motion to dismiss;
  - after unexpected developments in discovery; or
  - before the court decides a motion for summary judgment.
- If there is a related federal securities fraud class action, the shareholder derivative action may be stayed pending proceedings in that related action. In these circumstances, consider:
  - beginning settlement negotiations if the court in the securities fraud class action denies a dismissal motion in the securities fraud class action and the shareholder derivative action was stayed pending that court's ruling; or
  - approaching plaintiff's counsel during the stay to discuss the possibility of plaintiff voluntarily dismissing the shareholder derivative complaint or, dismissing certain directors and officers against whom the asserted claims appear weak or who are not central to the complaint.

Plaintiffs' Counsel Strategize About When to Begin Settlement Discussions

- Determine the optimal time to begin settlement discussions, which may depend on the strength of the claims and any motion to dismiss that defendants file.
- Consider informally approaching defense counsel about settlement shortly after filing the complaint to get an idea about their openness to negotiations.
- Consider negotiating before the court decides a motion to dismiss to capitalize on the uncertainty defendants face with the possibility of a costly litigation, specifically:
  - individual defendants, facing personal liability, may be particularly willing to negotiate during the pendency of a motion to dismiss to save resources and accomplish a swift end to the litigation; and
  - the nominal defendant, especially if the entity is a public company, may prefer to end the litigation rather than risk the negative impact a dismissal denial could have on the company's reputation and resources.
- Recognize that defense counsel most commonly begins negotiations after a court rules on a motion to dismiss (see Defense Counsel Strategize About When to Begin Settlement Discussions). This approach may nonetheless prove advantageous for plaintiffs if the case survives dismissal because:
  - the settlement value of the claims will be higher after the pleadings are closed; and
  - the defendants may be more incentivized to settle to avoid the costs and uncertainties of discovery and beyond.

Identify All Parties Necessary to the Agreement

- Understand who the relevant parties are in the litigation, which typically include:
  - the named shareholder plaintiffs;
  - individual current or former officer and director defendants; and
  - the nominal entity defendant.

  For more on the roles of these parties in shareholder derivative litigation, see Practice Note, Basic Principles of Shareholder Derivative Litigation: Parties in a Shareholder Derivative Lawsuit.
- Identify the client and the parties with whom the client is settling.
- Coordinate with co-defendants' counsel (if on the defense side) or co-lead plaintiffs' counsel (if on the plaintiffs' side).
- If there are parallel shareholder derivative actions that have not been consolidated or are pending in other jurisdictions, coordinate with defense counsel in those cases.
- Consider coordinating with defense counsel in any related federal securities fraud class action.
- For defense counsel, coordinate with nominal defendant's (the company's) counsel who are typically aligned with the individual defendants during the settlement phase.
- Decide on the treatment of relevant third parties (for example, joint tortfeasors) and whether the settlement agreement:
  - releases them from future claims or preserves their rights;
  - requires consent from any third parties, such as insurers; and
  - must address contribution, indemnity, or subrogation issues.

Involve Director & Officer Insurers

- Be aware that the nominal defendant company typically has director & officer (D&O) insurance that provides coverage for the company's directors and officers if they are sued in a shareholder derivative action and the D&O insurer often will pay for any monetary settlement amounts.
- Cultivate a good working partnership with insurers early in the litigation to:
  - help develop the settlement strategy in a shareholder derivative action to increase the likelihood that the insurer supplies all or a substantial amount of settlement funds;
  - establish a rational discussion of the issues, problems, and decisions that may arise during the lawsuit; and
  - avoid unnecessary disputes whenever possible.

For more on the role of director and officer (D&O) insurers in a shareholder derivative action settlement, see Practice Note, Settling a Shareholder Derivative Action: Role of D&O Insurers.

For a full discussion about working with D&O insurers throughout a shareholder derivative action, see Practice Note, Indemnification, Advancement, and D&O Insurance Coverage in Shareholder Derivative Litigation.

Consider Retaining a Mediator

- Recognize that counsel may find it challenging to manage the multi-party negotiations necessary to settle most shareholder derivative actions.
- Involve an independent mediator familiar with shareholder derivative actions to:
  - add expertise, impartiality, and credibility in dealing with all parties; and
  - foster constructive consideration by all parties of the issues at the heart of a negotiation and support the parties to achieve a favorable outcome.

For a collection of resources on the use of a mediator to help parties work toward a negotiated settlement of their dispute, see Mediation Toolkit.

Consider Governance Reforms

- Weigh whether governance reforms by the nominal defendant company would be a suitable settlement consideration, either in whole or in part, for the claims alleged.
- Defense counsel should keep in mind that the reforms must be:
  - acceptable to the board of directors; and
  - feasible for the company to implement, in terms of the amount of resources the company would

need to commit to the reforms, and the amount of time the reforms would be binding on the company.

- Plaintiffs' counsel may request limited discovery during negotiations to ensure any governance reforms would provide sufficient benefits to the company.
- Tailor any governance reforms to address the nature of the misconduct alleged to ensure the court considering whether to approve the settlement would find the reforms are meaningful.

For more on governance reforms, see Practice Note, Settling a Shareholder Derivative Action: Negotiating Settlement Terms.

Consider a Monetary Amount for Settlement

- Weigh whether the settlement should include a monetary amount, and consider that, although not all shareholder derivative action settlements include a monetary amount, for those that do, the amount can be substantial.
- Consider a monetary payment to the company, that may me be made by:
  - the defendants' D&O insurer;
  - the defendants; or
  - a combination of the D&O insurer and defendants, with the insurer typically paying a larger share.
- Consider a fund created by the company to support any agreed on governance reforms and that is paid for with contribution by the D&O insurer or by the company.

For more on monetary components of a shareholder derivative action settlement, see Practice Note, Settling a Shareholder Derivative Action: Monetary Amount.

Prepare for Discovery in Aid of Settlement

- To facilitate settlement, the company should be prepared to provide a limited set of non-public information to plaintiffs' counsel if they request it.
- Be aware that this limited discovery can occur before the settlement is finalized or after, as confirmatory discovery.
- Defense counsel should ensure they produce the information under applicable settlement privileges and under a confidentiality order that covers documents produced as part of settlement negotiations or mediation.
- Defense counsel should limit the documents produced to only those needed to further or confirm settlement negotiations, especially if governance reforms are on the table. Common categories of documents include:
  - minutes of relevant board meetings addressing the challenged transactions or conduct;
  - written presentations made to the board by outside advisors relevant to the challenged transactions;
  - internal company policies and procedures; and
  - relevant insurance policies held by the company.
- The parties may also agree that the plaintiffs can interview one or more individuals to aid in plaintiffs' assessment of settlement.

For more on discovery in aid of settlement, see Practice Note, Settling a Shareholder Derivative Action: Discovery in Aid of Settlement.

Define the Scope of the Claims to Be Settled

Ensure the settlement agreement:

- Specifies the claims the agreement covers, including the treatment of existing unknown claims and future claims.
- Releases the defendants from future shareholder derivative actions on the same underlying conduct or transactions.
- Accounts for other actions that are either:
  - parallel shareholder derivative actions filed in the same or a different jurisdiction that should be encompassed by the settlement agreement and then voluntarily dismissed after the court approves the settlement; or
  - a related federal securities fraud class action based on the same underlying transactions or alleged misconduct that typically is carved out of the settlement agreement.
- Provides that the court will retain jurisdiction to enforce the settlement agreement.

For a full discussion of related proceedings in the context of shareholder derivative action settlements, see Practice Note, Settling a Shareholder Derivative Action: Related Proceedings.

Discuss Attorneys' Fees and Costs

- Be aware that the common practice in shareholder derivative actions is that counsel do not begin to negotiate attorneys' fees and costs until after the settlement amount and terms are agreed to in principle.
- Consider that:
  - the amount of attorneys' fees differs depending on the complexity of the case, whether the settlement includes a monetary payment, and when in the litigation the settlement occurs;
  - counsel typically agree to an amount of fees and costs above which the parties will not object, but not to a specific amount, which must be decided by the court; and
  - the company's D&O insurer often agrees to pay the attorneys' fees and expenses but sometimes the company agrees to pay them.

Anticipate and Avoid Grounds for Objections

- Be aware that shareholder derivative action settlements typically require notice be given to the company's shareholders in a manner directed by the court.
- Discuss the deadline and process for objections to the proposed shareholder derivative action settlement. Common objections by shareholders are that the proposed settlement:
  - confers an inadequate benefit to the company;
  - contained unreasonable or excessive counsel fees and expenses;
  - included an overbroad release; or
  - was not the product of arm's-length negotiations.

For more on objections to a proposed shareholder derivative action settlement, see Practice Note, Settling a Shareholder Derivative Action: Objections to Settlement.

Confirm Governing Law, Forum, and Jurisdiction

- Ensure all parties agree on the governing law of the settlement agreement (including the jurisdiction and forum for any enforcement, if necessary).
- Recognize that most shareholder derivative action settlement agreements provide for the company's state of incorporation as the governing law and state or federal courts within that state as the exclusive forum. For many companies, Delaware is the state of incorporation and the Delaware Court of Chancery is the parties' chosen forum.

Discuss the Mechanics of Settlement

Come to an understanding with the other parties to the agreement about:

- Coordination for the preliminary and final approval hearings, including issues arising from joint submissions to the court.
- The contents of notice to the shareholders, where the notice will be made, and which party will bear the responsibility for making and paying for it.
- Whether to seek court approval for compensation paid to the named plaintiffs (sometimes referred to as incentive or service awards) and whether the amount would be paid out of the attorneys' fees and expense award or another method.
- Conditioning the agreement on board approval and preparation for defense and nominal defendant's counsel's swift presentation of the settlement agreement to the board to avoid approval delays.
- Other completion mechanics, including:
  - the practicalities of settlement as far in advance as possible before execution, such as advance circulation of relevant documents, advance execution of original and counterpart agreements, and the immediate exchange of monies on execution; and
  - other logistical items such as preparing voluntary dismissal papers for any related proceedings.

- Allowing time to set up the method of payment, which plaintiffs' counsel can facilitate by providing prompt payment instructions and a Form W-9, if necessary.
- Whether to issue an agreed-on form of joint public statement once the settlement is concluded.

For a full discussion of the various mechanics of settlement, see Practice Note, Settling a Shareholder Derivative Action.

Special thanks to Stephen P. Warren and Allison Kernisky, Holland & Knight for their contribution to this Checklist.