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In the News

How Derivative Will Derivative Claims Go?

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As companies grow and diversify their operations, including through mergers and acquisitions, the number of subsidiaries tends to grow and the structure of companies becomes more complex[1] — a trend that may continue as deal-making likely accelerates in the second half of 2023.[2]

Given the continuing complexities of corporate structures, various courts have recently continued to relax certain standing and capacity requirements for a direct derivative claim to permit someone with an ownership interest in a parent company to seek redress for a harmed subsidiary when that parent company refuses or is otherwise incapable of making an impartial business judgment to do so.[3] This has come to be known as a "double derivative" claim.

But how far have and will courts relax such requirements of a direct derivative claim to allow owners of parent companies to try to remedy harm caused to a subsidiary in which they have a beneficial interest? What about the subsidiary of a subsidiary?

As a recent example, the U.S. District Court for the Southern District of New York in Kleeberg v. Eber found in March that the plaintiffs' claims were appropriate even when "some of the claims in this case … are derivative (or double or perhaps triple derivative) claims on behalf of companies in the overall [company] structure."

Given the increasing prevalence of multifaceted company structures, this article examines the underlying rationale behind double derivative actions and how that same rationale arguably could be applied to assert triple, quadruple and even quintuple derivative claims.

The Nature and Importance of Derivative Claims

A derivative claim is asserted by someone who owns a direct and contemporaneous interest in a company, such as a shareholder, on behalf of that company against third parties, who are often the officers and/or directors of the company. A derivative claim is designed to remedy the harm done to the company due to the wrongful conduct of such third parties.

In the context of complex business litigation, direct derivative claims have become relatively common occurrences and are an important legal mechanism that allows shareholders or other holders of ownership interests in companies to seek redress for corporate mismanagement, self-dealing and other wrongful conduct.

Derivative actions are an essential medium for owners of companies, among other things, to enforce high standards of conduct by corporate fiduciaries. As multitiered companies continue to grow, including through acquisitions of or mergers with domestic and foreign companies, the use of derivative — and especially multiple derivative — actions become even more important.

Double Derivative Claims Generally

What about when the wrongful conduct at issue is causing harm to a subsidiary of the company in which your client owns an interest?

This is where the legal doctrine of a "double derivative" claim arises.

Less common than direct derivative actions, double derivative actions involve a plaintiff asserting claims derivatively on behalf of a parent company, which, in turn, is asserting claims derivatively on behalf of the parent's subsidiary for alleged wrongdoings causing harm to the subsidiary. Over time, various courts have allowed proper double derivative claims and, although sparse, even triple derivative claims.

A double derivative action usually occurs when, at the time of the alleged misconduct: (1) the plaintiff held an ownership interest in a parent entity, which owned the harmed subsidiary entity, or (2) the plaintiff held a direct ownership interest in a harmed stand-alone entity, but where — as a result of being later acquired — that entity became a wholly owned subsidiary of the acquiring company and the owners of the preacquisition entity became owners of the acquiring company.[4]

Generally, a double derivative claim should be asserted when the subsidiary suffered the injury — such that, in essence, the parent indirectly suffered the injury — which raises issues of capacity and standing.[5][6] And they have been applied to corporations as well as limited liability companies.[7]

Although beyond the scope of this article, such double derivative claims also require addressing issues applicable to direct derivative claims, including choice of law, presuit demand requirements and typical defenses. Such issues can be critical to the viability of any derivative claim.

For example, what law will control the requirements for the derivative claim, and the corresponding prerequisites concerning presuit demands, will impact the viability of any derivative action — whether direct or multiple.[8] Moreover, as recognized by the Delaware Chancery Court in the 2022 case FSD BioSciences Inc. v. Durkacz, such issues can be particularly complex when the parent and subsidiary entities are governed by different laws.[9]

Indeed, it is arguable that certain states do not necessarily recognize double derivative claims.[10] And typical defenses include the business judgment rule, mirror-image rule, failure of condition precedent, failure to join an indispensable party, waiver, statute of limitations, laches, ratification and unclean hands.[11]

Rationale for Double Derivative Claims

Courts across the country often look to decisions in Delaware for guidance on corporate law and derivative actions specifically.[12]

For example, one of the key cases addressing the rationale for double derivative claims, Lambrecht v. O'Neal, decided in 2010 in the Delaware Supreme Court, has been cited throughout the country.[13] The Lambrecht court explained that a double derivative action occurs when a shareholder of a parent entity — the plaintiff — brings a claim belonging to a wholly owned subsidiary of that parent entity.[14]

Of note, courts have diverged on whether a double derivative claim may be brought for a subsidiary that is majority controlled, as opposed to wholly owned.[15]

In sum, a double derivative action may be necessary "where the parent corporation's board is shown to be incapable of making an impartial business judgment regarding whether to assert the subsidiary's claim," according to the Lambrecht court,[16] which also noted that if a plaintiff was not permitted to bring a double derivative suit, then "there would be no procedural vehicle to remedy the claimed wrongdoing in cases where the parent company board's decision not to enforce the subsidiary's claim is unprotected by the business judgment rule."[17]

The Lambrecht court held that capacity and standing requirements applicable to a direct derivative claim are altered for a double derivative claim, and the contemporaneous ownership requirement — i.e., that the plaintiff must be an owner at the time of the alleged wrongdoing — is not strictly applied to a double derivative claim.[18]

In 2020, the Delaware Chancery Court later explained in Bamford v. Penfold LP that the purpose for the contemporaneous ownership requirement — i.e., "to prevent what has been considered an evil, namely the purchasing of shares in order to maintain a derivative action designed to attack a transaction which occurred prior to the purchase of the stock" — is not undermined so as long as the plaintiff had a beneficial ownership at the time of the injury.[19]

And the continuous ownership requirement — i.e., that the plaintiff must be an owner throughout a lawsuit — was modified such that it can be satisfied when the plaintiff owned shares in the parent entity "continuously throughout the pendency of the double derivative action."[20]

Applying the Rationale of Double Derivative Claims Even Further

Similar rationales, including by the Southern District of New York in March,[21] have been used to support a triple derivative claim, such as when the plaintiff holds an interest in a parent entity and a subsidiary's subsidiary is harmed.[22] And while some courts have extended the rationale underlying double derivative claims to triple derivative claims, published case law actually considering a quadruple, quintuple or further-multiple derivative claim is scarce, if not nonexistent.

Nevertheless, various courts have implicitly acknowledged that such a claim may be permissible by referring to "multiple" derivative claims and noting that such claims may arise when there are "one or more" intermediate subsidiaries.[23]

Moreover, the rationale underlying double and triple derivative claims — permitting an owner to intervene when a parent entity refuses or is otherwise incapable of making an impartial business judgment to seek redress for a harmed subsidiary — arguably applies, regardless of the number of intermediate subsidiaries that are involved.

And, given the number of multitiered entity structures, courts may soon have the opportunity to apply this rationale directly to quadruple, quintuple or further-multiple derivative claims. As recently as this year, courts have continued to address the doctrine of multiple derivative actions in various contexts,[24] including in Goyal v. Durkacz, a 2022 Chancery Court case involving a multitiered company with a parent entity incorporated under Ontario, Canada, law.[25]

Practice Pointers

Your client bought ownership interests in a company. Over time, that company's officers and directors created a multitiered corporate structure with various subsidiaries. The client thinks that wrongful conduct has damaged, and continues to damage, one of the subsidiary's subsidiary's subsidiaries, which in turn is causing harm to the parent company in which they own interests.

As multitiered companies continue to grow, including through acquisitions of or mergers with domestic and foreign companies, so will such complicated fact scenarios. Consider a multiple derivative action, and in so doing, carefully:

Analyze who suffered the harm, who caused the harm and why.

These basic first steps of litigation become more complicated when facing a web of interrelated entities, with often overlapping officers, directors, employees, and/or agents, and consolidated and/or commingled financials.

For example, depending on the controlling law, whether the harm was suffered by the company itself — e.g., all shareholders similarly suffered — or the shareholder suffered some "special injury" distinct from any other injury to the company may dictate if a derivative action is necessary ab initio.

And, for multiple derivative actions, it is especially important to determine which subsidiary suffered the harm so that you can determine whether you must consider a double, triple or further multiple derivative claim.

Moreover, it is important to consider whether the party that caused the harm owed the shareholder an individual duty versus a duty to the company itself. Some factual circumstances may involve the basis for both a direct and derivative claim.

Graph out the relationships between your client, the parent entity and any applicable subsidiaries, as well as the relationships and duties owed by whoever caused the harm, e.g., fiduciary duties.

Evaluate the controlling law(s) applicable to any such derivative claim.

This will affect not only the applicable causes of action, but also the viability of any multiple derivative action.

In addition, it will affect the requirements for properly asserting a derivative action, including any prerequisites for filing a derivative action, such as a written presuit demand letter and corresponding issues of the required particularity of any such demand letter, futility, the required response and related timing.

Evaluate any contracts and governing documents also governing the rights and obligations of the parties involved.

This should include any contracts involving your client, potential defendants, the parent entity and subsidiary entity or entities, as well as governing documents outlining the scope of officers and/or directors' powers.

Pay particular attention to any applicable contractual provisions concerning derivative claims, waivers, access to books and records, and indemnification.

Consider the strength of defenses typically raised in response to derivative claims.

For example, officers and directors generally owe fiduciary duties to a company. Depending on the controlling law, such duties may include, without limitation, duties of obedience, loyalty and due care. And the duty of care may be subject to the "business judgment rule" — e.g., the honest exercise of business judgment and discretion.

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[1] See, e.g., Governance of Subsidiaries – A survey of global companies, Deloitte (Sept. 2013) at*3 https://www2.deloitte.com/content/dam/Deloitte/in/Documents/risk/Corporate%20Governance/in-gc-governance-of-subsidiaries-a-survey-of-global-companies-noexp.pdf ("As companies grow in size and diversify their operations in the domestic market or expand to overseas markets, the number of subsidiaries tends to increase and the structures of the companies become more complex."); On the board's agenda — Governance in a multidimensional environment, Deloitte (Oct. 2016) at *1, https://www2.deloitte.com/content/dam/Deloitte/xe/Documents/risk/me_risk_on-the-board-agenda_sep2016.pdf ("As organizations expand their operations, many do so by creating or acquiring legal entities to operate in new markets or different jurisdictions . . . .").

[2] 2023 M&A Outlook: 4 Trends to Watch as Deal-Making Accelerates, Morgan Stanley (Feb. 10, 2023), https://www.morganstanley.com/ideas/mergers-and-acquisitions-outlook-2023-trends; ("[L]ooking ahead to the second half of 2023 and beyond, deal-making is likely to accelerate, according to Tom Miles and Brian Healy, Co-Heads of Americas M&A at Morgan Stanley." see also Kwok, Roberta, A Wave of Acquisitions May Have Shielded Big Tech from Competition, Yale Insights (Mar. 7, 2023), https://insights.som.yale.edu/insights/wave-of-acquisitions-may-have-shielded-big-tech-from-competition ("While it had been clear acquisitions were growing, 'I don't think anybody has quite so viscerally documented how big this shift has been,' [Florian] Ederer [an associate professor of economics at Yale School of Management] says.").

[3] E.g., Kleeberg v. Eber , No. 16-CV-9517 (LAK), 2023 WL 2711294, at *16 n.42 (S.D.N.Y. Mar. 30, 2023); Goyal on behalf of FSD BioSciences, Inc. v. Durkacz , No. CV 2021-0629-LWW, 2022 WL 1447382, at *2 n.26,*5 (Del. Ch. May 5, 2022); Mohinani v. Charney, 208 A.D.3d 404, 405–06, 173 N.Y.S.3d 1, 3 (2022) (court rejected plaintiffs' argument that its claims should be permitted as derivative or double-derivative claims because "[t]hroughout this decade-long litigation, through their posttrial submissions, plaintiffs consistently asserted these causes of action as direct claims on their own behalf, not as derivative or double-derivative claims."); cf. Schwaber v. Margalit , No. CV 2021-1038-LWW, 2022 WL 2719952, at *4 (Del. Ch. July 13, 2022) (court stayed lawsuit because "[n]either party has indicated that the arbitrators have declined to hear Schwaber's derivative or double derivative claims at this juncture (and that is a matter for the arbitrators—not me—to decide).").

[4] E.g., Lambrecht v. O'Neal , 3 A.3d 277, 282–83 (Del. 2010); see also Harris v. Wachovia Corp. , No. 09 CVS 25270, 2011 WL 1679625, at *7 n.58 (N.C. Super. Feb. 23, 2011).

[5] See, e.g., DiMare on Behalf of DiMare, Inc. v. DiMare , No. 2084CV01439BLS2, 2021 WL 3493553, at *4 (Mass. Super. Apr. 28, 2021) ("A double derivative suit is based upon the 'injury suffered indirectly by the parent corporation, in which the shareholder does have an interest, as a result of injury to the subsidiary.'" (internal citations and quotation marks omitted)); Neff v. Brady, 527 S.W.3d 511, 522 (Tex. App.—Houston [1st Dist.] 2017, no pet.) ("A double-derivative suit is based upon the "injury suffered indirectly by the parent corporation, in which the shareholder does have an interest, as a result of injury to the subsidiary.'"); White v. Hyde, No. 16 CVS 1330, 2016 WL 5853138, at *5 (N.C. Super. Oct. 4, 2016) ("A 'double derivative' claim by a shareholder of a parent company on behalf of the parent company—i.e., the company in which the plaintiff is actually a shareholder—is brought against the directors of the subsidiary for damages incurred by the parent company as a result of injury to the parent's value caused by injury to the subsidiary.").

[6] See, e.g., Lambrecht, 3 A.3d at 284–85 (analyzing the question of: "where a shareholder has lost standing to maintain a standard derivative action by reason of an acquisition of the corporation in a stock-for-stock merger, may that shareholder, in his new capacity as a shareholder of the acquiring corporation, assert the claim double derivatively . . . .").

[7] See, e.g., Bamford v. Penfold, L.P. , No. CV 2019-0005-JTL, 2020 WL 967942, at *27 (Del. Ch. Feb. 28, 2020) (permitting double derivative claim where parent entity is a limited partnership and subsidiary is an LLC); Robert v. Robert Mgmt. Co., LLC , No. 2013–C–1043, 2013 WL 8151042, at *1–2 (La. App. 4 Cir. Dec. 19, 2013) (permitting double derivative claims involving a parent LLC and subsidiary LLCs).

[8] See, e.g., Brown v. Tenney , 532 N.E.2d 230, 235–36 (Ill. 1988) ("a double derivative action may be maintained by a shareholder of record in a holding company, on behalf of a subsidiary controlled or dominated by the holding company, after due demand is made to, and rejected by, the subsidiary and the holding company"); Sneed v. Webre , 465 S.W.3d 169, 192 (Tex. 2015) ("We conclude that the Legislature has provided for double-derivative suits of this nature [under the closely held corporation statute, which does not require a pre-suit demand]. Were we to hold otherwise, the directors of a closely held holding corporation could create a wholly owned subsidiary to circumvent the Legislature's intent to make it easier for shareholders to assert derivative proceedings on behalf of closely held corporations.").

[9] See Goyal on behalf of FSD BioSciences, Inc. v. Durkacz , No. CV 2021-0629-LWW, 2022 WL 1447382, at *2 n.26, *5 (Del. Ch. May 5, 2022) (court held that "Delaware law does not provide [the plaintiff] with an avenue to press his claims at the subsidiary level [which is a Delaware entity] without first satisfying the derivative standing requirements that apply to [an entity incorporated under Ontario law].").

[10] See, e.g., Batchelder v. Kawamoto , 147 F.3d 915, 920 (9th Cir. 1998) ("California has never expressly recognized double derivative suits."); Cal-Nan Horizon Quest, Inc. v. Seitz Fam. P'ship, L.P. , No. G038751, 2008 WL 2352495, at *3 (Cal. Ct. App. June 10, 2008) ("The parties agree that the current law in California does not recognize a double derivative action.") (not published).

[11] See generally, e.g., 3 Treatise on the Law of Corporations § 15:17, The corporation as a passive party in derivative suits; defenses, (3d ed. Dec. 2022); 1 Shareholder Litigation § 9:22, Defenses—Plaintiff's conduct or status—Standing, collusion, clean hands, pari delicto, (Nov. 2022).

[12] See, e.g., Radin, Stephen A., "Sinners Who Find Religion": Advancement of Litigation Expenses to Corporate Officials Accused of Wrongdoing, 25 Rev. Litig. 251, 251 (2006) ("Delaware—'the Mother Court of corporate law' and the state whose 'rich abundance of corporate law' guides courts throughout the country . . . ."); Kopecky, Robert J., Derivative Litigation – A Primer, The Litigation Manual, ABA (3d. ed. 1999), at 656 ("Delaware has by far the most developed body of precedent in this area, and courts in other jurisdictions often look to Delaware decisions to fill gaps in their own law.").

[13] E.g., DiMare on Behalf of DiMare, Inc. v. DiMare , No. 2084CV01439BLS2, 2021 WL 3493553, at *2 (Mass. Super. Apr. 28, 2021) (citing Lambrecht and noting under Massachusetts law, "essentially the same standard would apply"); White v. Hyde, No. 16 CVS 1330, 2016 WL 5853138, at *6 (N.C. Super. Oct. 4, 2016) (citing Lambrecht and noting that "this Court may look to, but is not controlled by, Delaware law on the subject" of double derivative claims); In re Amerco

Derivative Litig., 252 P.3d 681, 705 (Nev. 2011) (Pickering, J., concurring in part) (citing Lambrecht in double derivative action).

[14] Lambrecht, 3 A.3d at 282.

[15] Id. at 283 n.14 (noting that, although Virginia, Ohio, and New York law permit a double derivative suit to be brought where the parent owns a controlling interest—but not 100%—of the subsidiary, "[t]o date, the Delaware courts have not addressed this specific question nor do we purport to do so, expressly or implicitly, in this Opinion."); see, e.g., Belendiuk v. Carrion , No. CV 9026-ML, 2014 WL 3589500, at *7 n.54 (Del. Ch. July 22, 2014) ("For purposes of this report, I will assume that Delaware law permits a parent company's stockholders to maintain a double derivative action on behalf of a majority-controlled subsidiary."); Saltzman v. Birrell , 78 F. Supp. 778, 783 (S.D.N.Y. 1948) (noting that it does not "appear a wise course to establish, on these motions [to dismiss], a minimum requisite stock ownership by the parent in the subsidiary for institution of a multiple derivative suit.").

[16] Lambrecht, 3 A.3d at 282.

[17] Id. at 283.

[18] Id. at 284, 289.

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