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Under Delaware Law, the Occurrence of Alleged Illegal Conduct at a Company Is Not Enough to Plead Demand Futility Sufficient to Give Stockholders Standing to Sue Derivatively

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In a shareholder derivative action, to survive a motion to dismiss for failure to plead facts showing demand futility, a derivative plaintiff must plead particularized facts showing either actual involvement by a majority of the board in illegal conduct or conduct amount to an intentional dereliction of duty. Illegal conduct at a company, untethered to board participation, is not enough. To the contrary, a board's consideration of and remedial response to alleged illegal conduct inoculates the board from derivative liability even where a stockholder plaintiff alleges, with the benefit of hindsight, that a different course of action would have been more favorable for the company. In *In re Qualcomm Inc. FCPA Stockholder Derivative Litig.*, No. CV 11152-VCMR, 2017 WL 2608723 (Del. Ch. June 16, 2017), the Delaware Court of Chancery rejected several conclusory arguments that illicit behavior by the company automatically supports an inference of director knowledge or involvement. The *Qualcomm* decision underscores that company directors should freely exercise their discretion when implementing remedial measures in response to company legal violations without fear that an enterprising set of plaintiff's attorneys will use those remedial measures to bootstrap derivative liability on the directors.

The Foreign Corrupt Practices Act ("FCPA") is a federal anti-bribery law that prohibits illegal payments to foreign government officials to keep or secure business. It also requires publicly traded companies to establish adequate internal controls for recording all company transactions and ensuring the company only executes authorized transactions. In March 2016, the U.S. Securities & Exchange Commission ("SEC") concluded that, from 2002 through 2012, Qualcomm Inc. engaged in several instances of conduct that violated the FCPA. As a result of the violations, the SEC and Qualcomm reached a settlement, which was released simultaneously with a cease-and-desist order. The order required Qualcomm to make periodic reports to the SEC for two years and pay a penalty of $7.5 million.

Plaintiffs filed a stockholder derivative complaint alleging that Qualcomm's board of directors knew of and consciously disregarded red flags regarding Qualcomm's FCPA violations in China and Korea. Specifically, the complaint alleged that at several meetings in 2009 and 2010, the Qualcomm Audit Committee learned of whistleblower allegations concerning FCPA violations and received internal reports of potential violations, including "[a] large number of activities such as business meals, business entertainment, marketing and gifts with known government related entities [that] have not been recorded" in the Qualcomm gift logs for China and Korea.

Plaintiffs brought claims of breach of fiduciary duty, waste, and unjust enrichment. Plaintiffs alleged that the defendant directors breached their fiduciary duties because, after instituting a reporting system, they consciously failed to oversee Qualcomm's operations "thus disabling themselves from being informed of risks or problems requiring their attention." However, the Delaware Court of Chancery determined that the complaint contained the seeds of its own demise. The reports supposedly constituting red flags, which the plaintiffs alleged showed board knowledge and disregard of illegal conduct, also contained planned remedial measures. This undermined any inference of bad faith.

Plaintiffs argued that the board's target date for translation of FCPA compliance materials into Chinese and formulation of a long-range FCPA plan were too late and thus evidenced a failure to respond to red flags. The Court, however, concluded that these allegations simply sought to second-guess the timing and manner of the board's response to the red flags and, therefore, failed to establish an inference of bad faith. In particular, the Court noted:

Plaintiffs also argue that the FCPA establishes a statutory floor for adequate internal controls, and because the Qualcomm cease-and-desist order describes internal control violations of the FCPA, the Complaint necessarily states a claim. But that argument is misplaced here. A corporation's violation of the FCPA alone is not enough for director liability under *Caremark*. "Delaware courts routinely reject the conclusory allegation that because illegal behavior occurred, internal controls must have been deficient, and the board must have known so." Delaware law, not the FCPA, establishes the standard for director liability, and under Delaware law, Plaintiffs' Complaint does not allege bad faith.

The Court further rejected the plaintiffs' claims of waste and unjust enrichment. As to waste, the complaint only alleged that waste occurred under the board's watch, but it did not allege that the board authorized any allegedly wasteful transactions. Absent particularized allegations linking the board to bribery or other illegal payments, the plaintiffs failed to show the board faced a substantial likelihood of liability on the count of waste. As noted by the Court, "[t]he corporation may very well have a claim against the employees who provided unauthorized gifts to foreign officials, but absent any particularized allegations tying the bribery to the board, the directors are competent to decide whether Qualcomm should pursue that claim." Likewise, the Court rejected the plaintiffs' claim that the directors were unjustly enriched because their compensation was purportedly based on "inflated" financial results because the complaint did not allege how the results were inflated or that the financial results had been restated.

Qualcomm confirms that a corporation's unlawful conduct alone is not enough to establish demand futility. To support an inference that a majority of the board would likely face personal liability, a derivative plaintiff must do more. Importantly, a board's disclosure of planned remedial actions may vitiate any competing inference of bad faith.

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