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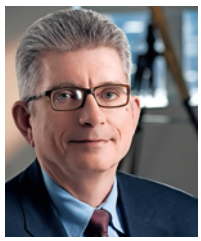
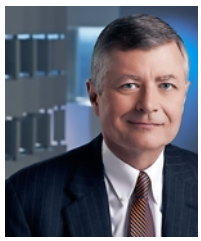
Data Breach Litigation

Recent cases indicate that directors can look forward to one bright spot in corporate data breach litigation: derivative actions are unlikely to pass a motion to dismiss absent plausible allegations of extreme misconduct, the authors write.

High Hurdles Faced by Data Security Breach Shareholder Derivative Plaintiffs

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Following a corporate data security breach, directors may well feel challenged by the civil and regulatory actions brought—or threatened—against the company. But recent cases indicate that directors can look forward to one bright spot: derivative actions are unlikely to pass a motion to dismiss absent plausible allegations of extreme misconduct. *Palkon v. Holmes*, a derivative action brought against Wyndham Worldwide Corp. and its directors, as well as *In re the Home Depot Inc. Shareholders Derivative Litig.*, underscore the difficulties that shareholder derivative plaintiffs face. Moreover, the actions taken by the directors at both of these companies illustrate specific actions by directors that can dissipate the risk of an adverse result in such litigation.

The difficulty faced by shareholder derivative plaintiffs is both intentional and appropriate. Corporate law is designed to ensure that the directors, not the shareholders, manage the affairs of the corporation. This includes determining whether the corporation should file a lawsuit. As a result, a shareholder who believes that a corporation should take legal action cannot bring that action without the board's approval. Only if the shareholder can prove that the board wrongfully refused to

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act, or that asking the board in the first instance would be futile, can the shareholder bring a derivative action independently of the board. *Palkon* demonstrates the difficulty in establishing the former, while *In re Home Depot* demonstrates the difficulty in establishing the latter.

In *Palkon*, the plaintiff shareholder filed his derivative action alleging that the board of directors wrongly refused to act on his demand that they ''investigate, address, and promptly remedy'' the alleged harm to the company resulting from three cyberattacks. Because the plaintiff made a demand on the board and the board denied the demand, the court evaluated the board's decision under the ''business judgment rule,'' which includes a presumption that the board acted ''on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company.'' *Palkon*, 2014 BL 293980 (quoting *Spiegal v. Buntrock*, 571 A.2d 767, 773 (Del. 1990)). The court therefore reasoned that, to defeat a motion to dismiss, plaintiff must overcome this presumption by pleading with particularity that the board's decision was either (i) ''made in bad faith,'' or (ii) ''based on an unreasonable investigation.'' *Id.* (quoting *In re Merrill Lynch & Co.*, 773 F. Supp. 2d 330, 351 (S.D.N.Y. 2011)). Unsurprisingly, the plaintiff in *Palkon* was unable to overcome the business judgment rule's weighty presumption.

First, the plaintiff argued that the board's refusal was in bad faith because it was influenced by conflicted internal and external legal counsel. This argument ultimately failed because the court found that neither counsel faced a conflict. But in reaching its conclusion, the court explained that merely establishing some conflict would have been insufficient. Rather, to overcome the strong presumption underpinning the business judgment rule, the plaintiff would have to establish that the allegedly-conflicted counsels' advice to refuse the demand rendered the refusal ''so far beyond the bounds of reasonable business judgment that its only explanation is bad faith.'' *Id.* (quoting *In re Tower Air, Inc.*, 416 F.3d 229, 238 (3d Cir. 2005)).

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Second, the plaintiff argued that the board's investigation was ''predetermined and thus unreasonable.'' *Id.* As to this argument, the court again found the plaintiff's burden to be substantial. Plaintiff was required to establish that ''the Board acted with so little information that their decision was unintelligent and unadvised.'' *Id.* (quoting *In re Gen. Motors Class E Stock Boyout Sec. Litig.*, 694 F. Supp. 1119, 1133 (D. Del 1988)). Based on the ''ample information'' provided to the company's board, and the ''numerous steps the Board took to familiarize itself with the subject matter of the demand,'' the court easily concluded that the board's decision was duly supported under the business judgment rule. The court ultimately granted the motion to dismiss.

The plaintiff shareholders in *In re Home Depot* took a different route to pursue their derivative action: the plaintiffs made no pre-suit demand, but rather proceeded directly to the filing of complaints alleging that a demand on the board would be futile. To avoid dismissal in these circumstances, the plaintiffs necessarily undertook to show that the board, even if given the chance, could not have properly exercised its independent and disinterested business judgment in responding to a demand.

The court in *In re Home Depot* made clear that a plaintiff's burden when seeking to bypass the board is no less heavy than that faced in *Palkon*. Rather, applying Delaware law, the court reasoned that the plaintiffs could succeed only if they established with particularized facts that a majority of the board engaged in conduct ''so egregious on its face that board approval cannot meet the test of business judgment, and a *substantial likelihood* of director liability therefore exists''—a demonstration that the plaintiffs in *In re Home Depot* could not accomplish. *In re Home Depot*, 2016 BL 397804 (quoting *Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1984)) (emphasis in original)

First, the plaintiffs claimed that the members of the board failed to fulfill their duty of loyalty by allegedly failing to create a reporting system to address cybersecurity concerns and a plan to immediately remedy alleged data security deficiencies. The court disagreed. Emphasizing the discretion afforded to boards, the court explained that ''directors violate their duty of loyalty only 'if they knowingly and *completely* failed to undertake their responsibilities.' '' *Id.* (quoting *Lyondell Chemical Co. v. Ryan*, 970 A.2d 235, 243-44 (Del. 2009) (emphasis in original). The court easily found that the board members fulfilled their duty, as the complaint acknowledged that the board had received briefings on the state of The Home Depot's security from both management and the audit committee and had implemented, before the data breach, a plan to enhance data security.

Second, the plaintiffs claimed that the majority of directors could be liable for corporate waste based on (1) insufficient action to address cybersecurity threats and (2) their approval of a supposedly ''lavish'' compensation package to the Chief Information Officer (CIO). Pls.' Resp. to Defs.' Mot. to Dismiss, at 25. However, as the court explained, both of these allegations effectively challenged the board's exercise of its business judgment. The court quickly dismissed the plaintiffs' insufficient-action argument, finding that the board's decision about when and how to address the company's cybersecurity falls squarely within the discretion of the board. As to the contention regarding payments to the CIO, the court explained that the board's discretion to set compensation is not unlimited, but could only lead to director liability if it was ''so disproportionately large as to be unconscionable.'' *In re Home Depot*, 2016 BL 397804 (quoting *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000)) (internal quotation omitted). Here, the court found that the compensation package provided to the CIO could not be shown to exceed that bar, and thus was a valid exercise of business judgment. Accordingly, the court in *In re Home Depot*, like the court in *Palkon*, granted the motion to dismiss.

Importantly, in both cases discussed above, the court's discussion cited positively to particular actions taken by the companies' boards that directly contra-

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dicted the plaintiffs' efforts to impugn the board's conduct. To minimize the risk of a derivative action, directors of companies generally should consider taking similar steps, such as:

■ *Establishing an enterprise-wide cybersecurity strategy and program*—In *In re Home Depot*, the complaint acknowledged that, prior to the data breach, The Home Depot USA Inc. had a data security program in place and instituted a plan to further enhance that program. Likewise, in *Palkon*, the plaintiff conceded that the company had implemented security measures prior to the first of the three cyberattacks and then addressed such concerns numerous times. The courts in these cases cited such actions as weighing against any claim that the directors had fallen short of any duties as directors to anticipate that cyberattacks may occur.

■ *Discussing cybersecurity (including reports about recent data breaches) at a senior level*—In *In re Home Depot*, the complaint acknowledged that The Home Depot's Audit Committee and Board of Directors received regular reports on the state of the company's data security. Likewise, in *Palkon*, Wyndham's Board of Directors discussed the cyberattacks at fourteen meetings over six years, and received a presentation from the general counsel each quarter about the cyberattacks or the company's data security. The courts in these cases cited such actions as weighing against any claim that the directors had fallen short of any director duty to ensure that a reasonable system of reporting existed, or somehow had failed to have enough information to be able to assess, and deny, plaintiff's demand.