

CORPORATE AND SECURITIES LITIGATION

Expert Analysis

The Business Judgment Rule And Corporate Data Breaches

Large-scale corporate data breaches have unfortunately become increasingly common events, posing a variety of challenges to the companies that suffer them. A few weeks ago, a district court in Georgia dismissed one of the first shareholder derivative actions that challenged the adequacy of a corporation's data-breach prevention strategy. While that court held that the business judgment rule shielded the company's actions, it remains to be seen whether that position becomes the majority one.

Background

On Nov. 30, 2016, the U.S. District Court for the Northern District of Georgia dismissed a derivative action brought by shareholders of home improvements giant The Home Depot, Inc. in the wake of a 2014 data breach, in which hackers stole over 56 million customers' personal financial information. All told, according to the complaint, the breach could cost Home Depot nearly \$10 billion in liability from credit-card fraud, card reissuances, and lawsuits from banks and credit unions that suffered from the breach.

Shareholders alleged that certain Home Depot officers and members of its Board of Directors breached their duty of loyalty by disbanding the



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committee responsible for IT oversight and acting too slowly in remedying out-of-date data-security technology. In addition to the duty-of-loyalty claim, the shareholders asserted claims of corporate waste as well as a violation of Section 14(a) of the Securities Exchange Act.

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In evaluating the Home Depot's motion to dismiss, the court devoted most of its opinion to discussing whether the shareholders, who did not make a demand on the board, adequately pleaded particularized facts showing that demand would have been futile, as required by Delaware law.¹ On all three claims, Judge Thomas W. Thrash, Jr. found that they did not, because the shareholders could not show "beyond a reasonable doubt"

that Home Depot's actions fell outside decisions protected by the business judgment rule.

Duty of Loyalty

To determine whether the shareholders adequately pleaded demand futility as to their claim that Home Depot breached its duty of loyalty, the court looked to three different pleading standards under Delaware law: (1) the standard for demand futility; (2) the standard for asserting that board members were unable to act independently; and (3) the standard for breach of the duty of loyalty.

For demand futility, the court cited the Delaware Supreme Court's decision in *Rales v. Blasband*, which set the test for when demand on the board is excused: when the particularized facts raise a reasonable doubt that a majority of the board was able to act independently. 634 A.2d 927, 934 (Del. 1993); accord *In re Citigroup Inc. Shareholder Derivative Litig.*, 964 A.2d 106, 121 (Del. Ch. 2009). Next, the shareholders had the burden to plead conduct that was "so egregious on its face" that the board's actions could not have been an exercise of business judgment. *In re Citigroup Inc.*, 964 A.2d at 121. Finally, to show that board members had breached their duty of loyalty, the shareholders had to plead that they "knew they were not discharging their fiduciary obligations or [] demonstrated a *conscious* disregard for their responsibilities such as by failing to act in the face of a known duty to act."

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In re Home Depot, Inc. S'holder Derivative Litig., 1:15-cv-2999 (TWT), 2016 WL 6995676, at *5 (N.D. Ga. Nov. 30, 2016) (emphasis in original) (quoting *In re Citigroup Inc.*, 964 A.2d at 123).

Attempting to combine these three standards, the court held the shareholders to the burden of asserting “particularized facts beyond a reasonable doubt that a majority of the Board faced substantial liability because it consciously failed to act in the face of a known duty to act.” *In re Home Depot*, 2016 WL 6995676, at *5. In this context, the court’s use of the phrase “beyond a reasonable doubt” (which is the burden prosecutors must carry to convict criminal defendants) seems curious. Presumably, the court was referring to the formidable bar a plaintiff must clear to overcome the deference afforded to directors and officers by the business judgment rule.

Because the shareholders alleged both that the board received regular briefings on the data-security risk and that it had approved some plan to address those risks, the court essentially found that the shareholders had made Home Depot’s case for it. Deferring to the board’s business judgment, the court found that although the breach revealed that the board’s remediation plan was implemented too slowly, hindsight could not make an imperfect decision unreasonable. Thus, the shareholders could not prove beyond a reasonable doubt that the majority of the board consciously disregarded a known duty to act. And, without that showing, the shareholders could not meet their burden to show that demand was futile.

Corporate Waste

The court also evaluated whether the shareholders’ corporate-waste claim satisfied demand futility. Under *Aronson v. Lewis*, the shareholders must show a reasonable doubt that the challenged transaction was “the product of a valid exercise of business judgment.” 473 A.2d 805, 814 (Del. 1984). The shareholders argued that the court should consider

loss stemming from the breach as corporate waste. The court, however, reframed the argument as an assertion that the board made a “‘wrong’ decision” by addressing the security risk “at a leisurely pace.” *In re Home Depot*, 2016 WL 6995676, at *6. The court quickly determined that this decision, however “unfortunate,” fell neatly within the board’s exercise of business judgment.²

Section 14(a) of Securities Act

Finally, as to the alleged violation of Section 14(a) of the Securities Exchange Act, the court relied on principles of Delaware General Corporation Law and Supreme Court precedent to hold that (1) the demand requirement applies, (2) the heightened pleading requirements of the Private Securities Litigation Reform Act apply, and (3) demand was not excused.

The shareholders’ chief allegation was that Home Depot did not disclose in its 2014 Proxy Statements that it knew about specific data-security threats, nor did it disclose that the charter for the Audit Committee, which was supposed to take over responsibility for data security from the disbanded IT committee, was never amended to include such a responsibility.

The court quickly dismissed the latter claim as immaterial, given that “everyone believed and acted as if the [Audit] Committee [had] oversight over data security.” *Id.* at *8. But, with respect to the omission claim, the court reasoned that the shareholders failed to name any specific statements rendered misleading or false by the omission and failed to plead with particularity both transaction loss and loss causation. *Id.* at *9.

Similar to the standard articulated for demand futility in the breach of the duty of loyalty context, the court held shareholders’ demand-futility pleading to a high standard, finding that they had “not shown beyond a reasonable doubt that the Defendants would have been interested in the litigation because [the shareholders had] not demonstrated a substantial likelihood that the Defendants would have been liable for a

Section 14(a) violation.” *Id.* Finding that demand was not excused on this claim either, the court granted Home Depot’s motion to dismiss under Rule 23.1 and did not reach its 12(b)(6) arguments.

Takeaways

Infused throughout the decision is a key principle underlying Delaware’s General Corporation Law that “directors, rather than shareholders [should] manage the business and affairs of the corporation.” *Id.* at *3 (quoting *Stepak ex rel. Southern Co. v. Addison*, 20 F.3d 398, 402 (11th Cir. 1994) (quoting *Aronson*, 473 A.2d at 811)). Holding the shareholders to high demand-futility pleading requirements is both consistent with and reinforces Delaware’s deference to the corporate board as decision-maker. Boards of Directors fearful of being held responsible when outmaneuvered by professional hackers have an ally in Delaware law. So long as they approve a plan to prevent breaches like this, the business-judgment rule continues to offer significant protection.

That said, other courts may not be so understanding. And, if the number of hacking incidents increases (and the threat to data security for large, public companies becomes more concrete), it is possible that what constitutes a reasonable plan could change, making the outcome of a suit like this more difficult to forecast.



1. The shareholders argued that demand would be futile because a majority of the board members were “disqualified from fairly evaluating the derivative claims because they [were] responsible for the damages suffered by Home Depot as a result of the [breach].” Am. Compl. at ¶259.

2. The court also dismissed the shareholders’ second corporate-waste claim, relating to one of the board members’ compensation package, as untimely and without merit. The court found that executive compensation decisions, especially those relating to current employees, are entitled to “significant deference,” and that demand was not excused on that basis either. *Id.* at *7.