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2 Key 10th Circ. Holdings In Western Union Derivative Suit

By **Chris McCall and Luke Ritchie** (May 21, 2019, 3:01 PM EDT)

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On April 16, 2019, the U.S. Court of Appeals for the Tenth Circuit decided City of Cambridge Retirement System et al. v. Hikmet Ersek et al.,[1] a little-noticed decision but one that, nonetheless, has broad implications for shareholder derivative actions. The case concerned shareholders' allegations that the officers and directors of the Western Union Company breached their fiduciary duties to the company by willfully failing to implement and maintain an effective anti-money laundering compliance program.

In one fell swoop, the decision resolves an issue of first impression within the Tenth Circuit, exacerbates an existing circuit split, clarifies the necessity of presuit demands in shareholder derivative actions, and affirms the exacting nature of judicial review under a Federal Rule of Civil Procedure 23.1[2] when shareholders claim that a presuit demand on a company's board of directors would have been "futile."

Case Background

Cambridge arose from Western Union's[3] well-documented troubles complying with AML compliance requirements imposed by federal law. Under the Bank Secrecy Act of 1970, financial institutions, such as Western Union, must implement and maintain effective AML compliance programs to guard against and monitor money laundering.[4] As a company facilitating electronic money transfers through a sprawling international network of approximately 550,000 agents, Western Union was (and is) uniquely vulnerable to criminal exploitation.

For this and other reasons, beginning in 2002, state and federal regulators throughout the country began investigating Western Union's compliance with AML requirements. Between 2002 and 2010, Western Union entered into multiple settlement agreements with state and federal authorities in Arizona, California and New York concerning its alleged AML violations. Through these agreements, Western Union promised to remedy deficiencies in record-keeping, reporting and monitoring practices. Time and again, the company fell short.

In 2010, Western Union entered into the Southwest Border Agreement, or SBA, with Arizona. Therein, Western Union admitted that it had "reason to know" its agents at 16 locations had "knowingly engaged

in a pattern of money laundering violations that facilitated human smuggling from Mexico into the United States through Arizona," agreed to pay a $94 million fine, and committed to work with a court-appointed monitor to improve its AML compliance. After repeatedly failing to comply with the bevy of AML-related improvements required by the SBA, the parties extended the agreement through December 2017.

At the same time as these events were unfolding, federal regulators began actively investigating Western Union's AML compliance. U.S. attorneys' offices in California, Florida and Pennsylvania launched investigations into Western Union's alleged involvement with AML violations, money laundering and other fraudulent conduct, and the Federal Trade Commission began investigating the company's possible connection to facilitating fraudulent money transfers.

Against this backdrop, various shareholders filed derivative actions against several of Western Union's officers and directors, alleging they caused the company to willfully violate AML laws and regulations, and asserting violations of the Securities Exchange Act of 1934, breaches of fiduciary duties and Delaware common law claims. Ultimately, these derivative actions were consolidated in the United States District Court for the District of Colorado. At no time before filing suit, did the shareholders make a presuit demand on Western Union's board.

Following two rounds of dismissal and subsequent amendment of the complaint and while the case was still pending, Western Union entered into a deferred prosecution agreement with the U.S. Department of Justice. Therein, the company admitted its agents had engaged in fraud, money laundering and structuring schemes, and acknowledged that the company had willfully failed to implement an effective AML compliance program.

At the same time, Western Union announced a settlement with the FTC on related civil charges. The shareholders then obtained leave to file a second amended complaint to add allegations related to these events. The directors then moved to dismiss the second amended complaint under Rule 23.1 of the Federal Rules of Civil Procedure, arguing the shareholders failed to plead facts sufficient to show the futility of making a presuit demand. Once again, the district court granted dismissal. The shareholders then appealed to the Tenth Circuit.

The Tenth Circuit's Decision

The Tenth Circuit rendered two key holdings. First, resolving an issue of first impression in its circuit, the court held the standard of review on appeal of dismissals under Rule 23.1 for failure to plead demand futility is de novo. Noting that the federal courts of appeals are split on this question and that, historically, appellate courts have applied an abuse of discretion standard, the Tenth Circuit joined in the "recent trend" favoring de novo review.

As the court explained, because the question whether a demand is futile depends on the legal sufficiency of the complaint's allegations, and because the Tenth Circuit (and all federal courts of appeals) apply a de novo standard when reviewing the dismissal of a complaint, there was "no sound reason to apply a different standard to a derivative pleading." Thus, the Tenth Circuit joined the First, Second, Sixth, Seventh and Eighth Circuits in holding that a de novo — not an abuse of discretion — standard applies when evaluating a district court's dismissal of a complaint pursuant to Rule 23.1 for failure to sufficiently plead demand futility.

Second, the court held the shareholders' second amended complaint — despite containing substantial

allegations of misconduct by Western Union and/or its board and reciting the company's documented history of AML violations — insufficiently pled why the shareholders' failure to make a presuit demand on Western Union's board was futile and therefore excused under Federal Rule of Civil Procedure 23.1.

In so holding, the court confirmed that Rule 23.1 requires a complaint to "state with particularity" any "effort by the plaintiff to obtain the desired action from the [corporation's] directors" and "the reasons for not obtaining the action or making the effort."[5] The court first noted, under U.S. Supreme Court precedent, whether a complaint's allegations meet the requirements of Rule 23.1 is determined by the substantive law of the state in which the entity is incorporated.[6] The court thus applied Delaware law in determining whether the shareholders' second amended complaint was sufficient.

Because the shareholders' second amended complaint alleged *inaction* by Western Union's board, as opposed to action in violation of its fiduciary duties, to show demand futility under Delaware law, the shareholders were required to raise "a reasonable doubt" that, when the lawsuit was filed, Western Union's board "could have properly exercised its independent and disinterested business judgment in responding to a demand."[7] More specifically, under Rales v. Blasband, a derivative complaint must plead "facts *specific to each director*"[8] demonstrating that at least half of them could not have exercised disinterested business judgment in responding to a demand because they faced a substantial likelihood of personal benefit or liability. The Tenth Circuit went on to volunteer its concurrence with the Delaware Chancery Court's ominous assessment that, because the shareholders' complaint was predicated on the alleged failure of Western Union's board to exercise oversight, it presented "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[9]

Although courts typically assess demand futility based on the board of directors in office when a complaint is filed, because the shareholders had filed a second amended complaint in March 2017, the Tenth Circuit held that the relevant board for purposes of the Rule 23.1 analysis was Western Union's board at that time. This, in turn, was critical.

Six of the 12 members of Western Union's Board in March 2017 had joined in 2012 or later, long after the "red flag" events cited by the shareholders — the settlements with state and federal authorities from 2002 to 2010 — had occurred. And while the shareholders' second amended complaint contained generalized allegations that some board members were aware of systemic deficiencies at the company, contained a few specific allegations regarding three board members, and recited Western Union's long problems with AML compliance, the Tenth Circuit held that these allegations were insufficient.

At best, the court held, the complaint alleged that the "collective board" remained "wholly passive" in the face of AML compliance problems. Thus, after conducting what can only be described as a thorough and exacting review, the Tenth Circuit held that the shareholders' second amended complaint failed "Rule 23.1's rigorous pleading standard" because it lacked "particularized allegations as to what each Director knew and how they acted on that knowledge."

The Tenth Circuit therefore affirmed the lower court's dismissal.

Implications

The court's opinion in Cambridge is notable in several respects. To begin, by holding that a de novo standard of review applies to evaluate Rule 23.1 dismissals for failure to plead demand futility, the decision exacerbates a previously existing circuit split. Six circuits (including the Tenth Circuit) now hold that a de novo standard of review applies, while four circuits (the Third, Ninth, Eleventh and D.C.

Circuits) utilize an abuse of discretion standard of review. Going forward, the opinion in Cambridge may well provide another reason for the Supreme Court to ultimately resolve this issue.

Perhaps more importantly, however, the opinion demonstrates that federal courts will — and should — engage in a detailed and rigorous review when evaluating derivative actions alleging that a presuit demand was futile. This is particularly so given that Western Union, unlike many other companies that face similar derivative actions, had a well-documented history of the very same compliance problems that formed the basis of the shareholders' complaint. In effect, the opinion affirms that courts have a mandate to undertake — and undertake seriously — their obligation to weed out derivative complaints that have not gone through the proper corporate channels.

Finally, the decision is welcome news for boards of directors across the country, many of whom rightly feel that the plaintiffs bar should not be allowed to shoehorn criminal or civil investigations by state and federal authorities into expensive and time-consuming parallel shareholder derivative actions.

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[1] (No. 17-1381)

[2] Fed. R. Civ. P. 23.1

[3] Cambridge involved alleged AML violations by both Western Union and various affiliates and subsidiaries. For simplicity, this article uses "Western Union" to refer to each of these various entities.

[4] See 31 U.S.C. § 5318.

[5] Fed. R. Civ. P. 23.1(b)(3).

[6] Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, 108-09 (1991).

[7] Rales v. Blasband, 634 A.2d 927, 934 (Del. 1993).

[8] Desimone v. Barrows, 924 A.2d 908, 943 (Del. Ch. 2007); Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1049 (Del. 2004).

[9] In re Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959, 967 (Del. Ch. 1996).