THE BRIEF

FINANCIAL SERVICES LITIGATION QUARTERLY

SUMMER 2024

HUNTON
ANDREWS KURTH

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INSTITUTIONAL OWNERS OF SINGLE-FAMILY RENTAL PROPERTIES FACE LITIGATION RISKS THAT ARE DIFFERENT FROM TRADITIONAL LANDLORDS

Institutional ownership of single-family rental properties has grown markedly since the Great Recession, with institutions—publicly traded companies, private equity firms (through portfolio investments) and real estate investment trusts—currently estimated to own 574,000[1] to 700,000[2] single-family properties in the United States. Though currently making up only 3.8 to 5.0 percent of the 14.1 to 15.1 million single-family rental properties nationwide, institutional ownership continues to grow, with one report suggesting that, by 2030, institutions may own 7.6 million properties, or more than 40 percent of all single-family rentals.[3]

Landlord-tenant litigation is, of course, a mainstay of court dockets. On the surface, it might seem that institutional landlords confront the same liability risks faced for decades by individual landlords, just with a higher volume of cases, owing to the greater number of properties in their portfolios. The litigation risk profile for institutions though is different. The same things that make institutional ownership an attractive business model—e.g., scale, standardization of processes—also increase litigation risk. Institutional landlords face the same claims as individual landlords, but they also face aggregated claims challenging their processes and conduct across entire portfolios. And these aggregated claims can bring in new parties, which increases the likelihood of litigation and the dollar value of the claims at issue.

[1] Urban Institute, A Profile of Institutional Investor-Owned Single-Family Rental Properties, April 2023, at 7.

[2] Yardi Matrix, Build-to-Rent Fuels Growth in Institutional Single-Family Rental Market, July 2022, citing an unpublished research paper by MetLife Investment Management.

[3] *Id.*

Recent cases show how the aggregated nature of institutional ownership changes the litigation risk profile. The cases touch on different aspects of the single family rental business: the setting of rents, the renovation of properties and day-to-day property maintenance. The common theme though is that the aggregated nature of the business model makes it more efficient to bring litigation with greater potential liability, or to bring suit on claims that otherwise may have not resulted in litigation at all.

The California Attorney General earlier this year filed an action against Invitation Homes Inc., alleging that Invitation failed to comply with rent-increase provisions and California's pricing gouging law during COVID-19 for approximately 1,900 of the 12,000 single-family properties that Invitation owns in California.[4] The case was settled shortly after it was filed, with Invitation agreeing to pay approximately $1.7 million in restitution, plus civil penalties of $2.04 million.[5] It is difficult to know the exact financial effect here of the aggregated nature of the claims. Some number of affected tenants likely would have brought their own claims, or sought to resolve the alleged overcharges directly with the company. But some number, perhaps unaware of the alleged violations or believing that raising the issue was not worth the trouble, may not have done so, meaning that Invitation's liability (which included statutory penalties) likely was greater than what it would have faced if ownership of the 1,900 affected properties was dispersed.[6]

Another attorney general, this time in Minnesota, brought suit against HavenBrook Homes and affiliates for their management and maintenance of their portfolio of 600 single-family properties in Minnesota.[7] The Attorney General alleged that HavenBrook failed to properly repair and maintain homes across its Minnesota portfolio, including failing to provide adequate heat, failing to remediate lead paint hazards and failing to address unsecured premises. The Attorney General's claims likely were colored by HavenBrook's having advertised that its large portfolio of homes nationwide allowed it to offer a "24/7 Maintenance Line" that could "immediately dispatch emergency service day or night."[8] The "maintenance line" however was alleged to be only a third-party call center, which had no ability to send personnel to make repairs or perform maintenance, but could only pass along messages to defendants' offices. HavenBrook ultimately settled the Attorney General's claims earlier this year for $2.2 million and rent forgiveness of $2.0 million, but significantly, also agreed to sell the properties in its Minnesota portfolio to affordable housing entities.[9]

The most worrisome trend for institutional landlords is that the aggregation of properties is attracting the attention of third parties that otherwise would be wholly foreign to the landlord-tenant relationship. The federal government and some states allow third parties to bring actions on the government's behalf. The third-party relators are motivated to do so because they receive a significant share (up to 30 percent, in the case of a federal *qui tam* action) of any recovery. Damages also can be trebled. Thus, in *City of San Diego v. Invitation Homes Inc.,*[10] a relator brought an action on behalf of several California municipalities, alleging that Invitation failed to obtain permits for maintenance and repairs on some of the 12,000 single family units Invitation was alleged to own in California. The relator claimed that Invitation's failure deprived the municipalities of millions of dollars in permit fees and taxes, because renovations would have triggered a re-assessment likely to have

[4] *People v. Invitation Homes Inc.,* Case No. 24STCV00461, Los Angeles Cty. Super. Ct., Jan. 8, 2024.

[5] *Id.* Final Judgment and Permanent Injunction, Mar. 1, 2024.

[6] It is, of course, unlikely if all 1,900 properties were owned by different landlords, that each one also would have adjusted rents in the same way that gave rise to liability. The issue though highlights the potential pitfalls of managing large property portfolios: One decision can affect many properties, so a decision that runs afoul of a law or regulation can result in significant liability.

[7] *State v. HavenBrook Homes, LLC*, Court File No. 62-CV-22-780, 2d Jud. Dist., Ramsey Cty., Feb. 10, 2022.

[8] *Id.* at ¶40.

[9] *Id.*, Consent Judgment, Mar. 14, 2024, at ¶¶16-20, 36, 38.

[10] No. 3:22-cv-00260-BAS-MMP, S.D. Cal., Feb. 24, 2022.

resulted in higher taxes. Of particular note here is the identity of the relator. The case was originally brought by Deckard Technologies, a company that developed software used to assess compliance with short-term property rental laws. Deckard's interest in the case then was transferred to Blackbird Technologies, LLC. Blackbird is alleged to be related to Deckard, but an online search also suggests that it is a serial initiator of patent infringement lawsuits on behalf of small patent owners against large corporations. The court last year denied Invitation's motion to dismiss, and the case is currently set for trial in April 2025.

There's nothing novel or particularly noteworthy about the substance of the claims in the cases discussed above. The claims—rent overcharges, failure to maintain properties, failure to obtain permits—likely all would be found on the dockets of local courts where landlord-tenant and property disputes are handled. What's different is that the aggregated nature of institutional ownership changes the dynamics of bringing suit on these claims. The cases involving the California and Minnesota attorneys general, for example, can on one hand be seen as an unsurprising reaction to issues affecting more than a trivial number of the attorneys general's constituents. On the other, the cases make all affected properties in a portfolio part of the litigation. This is a different risk than faced by individual landlords. Tenants

at 123 Main Street may have brought an individual case regarding a rent overcharge, but tenants at 456 Oak Street may not have done so, perhaps because of ignorance, a conclusion that the issue isn't a problem, or that litigation to correct the problem is not worth the hassle. But because institutional ownership allows a party such as an attorney general or an entrepreneurial class action lawyer to bring suit more efficiently on many claims, the issues at 456 Oak Street become subject to litigation and potential liability. The same goes for the *qui tam* case against Invitation. The fact that the properties are owned by an institutional landlord did not invent claims where none previously existed. But aggregated ownership makes it easier to aggregate claims, which can attract additional parties as plaintiffs, even if they are third parties to the landlord-tenant relationship.

The cases discussed above suggest that the litigation risk profile for institutional landlords is similar to that of consumer-facing financial institutions. Hence, institutional landlords should be taking steps to mitigate the same sorts of risks faced by those consumer-facing institutions. For example, how are property managers communicating with tenants? If by text or pre-recorded call (to, say, remind tenants that rent is overdue), are the processes and systems being used for those communications compliant with the Telephone Consumer Protection Act? Does credit reporting comply with the Fair Credit Reporting Act, the exact requirements of which can differ depending on which federal court of appeals has jurisdiction? Is the institution undertaking internal analyses to determine whether its policies on things like rent abatement and security deposits comply with fair housing laws and are not having disproportionate impacts on protected classes of tenants?

The bottom line for institutional landlords is that their litigation risks resemble those faced by other consumer-facing businesses in the financial services industry, and so they must be prepared to mitigate those risks and defend claims accordingly.

NOTEWORTHY

NINTH CIRCUIT: ABSENT CLASS MEMBERS GIVEN BENEFIT OF DOUBT ON *AMERICAN PIPE* TOLLING WHEN CLASS DEFINITION IS AMBIGUOUS

In *American Pipe & Construction Co. v. Utah*, the Supreme Court held that the "[c]ommencement of a class action suspends the applicable statute of limitations as to all asserted members of the class." 414 U.S. 538, 554 (1974). A decade later, the court addressed how long *American Pipe* tolling lasts, holding in *Crown, Cork & Seal Co., Inc. v. Parker* that "[o]nce the statute of limitations has been tolled, it remains tolled for all members of the putative class until class certification is denied." 462 U.S. 345, 354 (1983). The Supreme Court has, however, not addressed when *American Pipe* tolling ends for people who were members of the putative class alleged at the commencement of a case, but who are not part of the class the named plaintiff actually moves to certify.

In *Defries v. Union Pac. R.R. Co.*, 104 F.4th 1091 (9th Cir. 2024), the Ninth Circuit considered the issue as a matter of first impression in the circuit. Defries worked as a conductor for Union Pacific until 2018, when he failed a routine color-vision test in the railroad's fitness-for-duty program. At that time, a putative class action had already been filed by a group of employees, claiming that Union Pacific's fitness-for-duty program violated the Americans with Disabilities Act. *Harris v. Union Pacific Railroad Co.*, 329 F.R.D. 616, 628 (D. Neb. 2019). There is no dispute that Defries was a member of the class originally pled in *Harris*.

However, the *Harris* plaintiffs moved to certify a class that was narrower than the one pled in the complaint, including only those subject to a fitness-for-duty examination due to a "reportable health event." The narrowed *Harris* class was certified in the trial court but later decertified by the Eighth Circuit. No notice was provided to members of the putative class alleged in the *Harris* complaint who were not included in the class actually certified. *Harris v. Union Pacific Railroad Co.*, 953 F.3d 1030, 1032 (8th Cir. 2020).

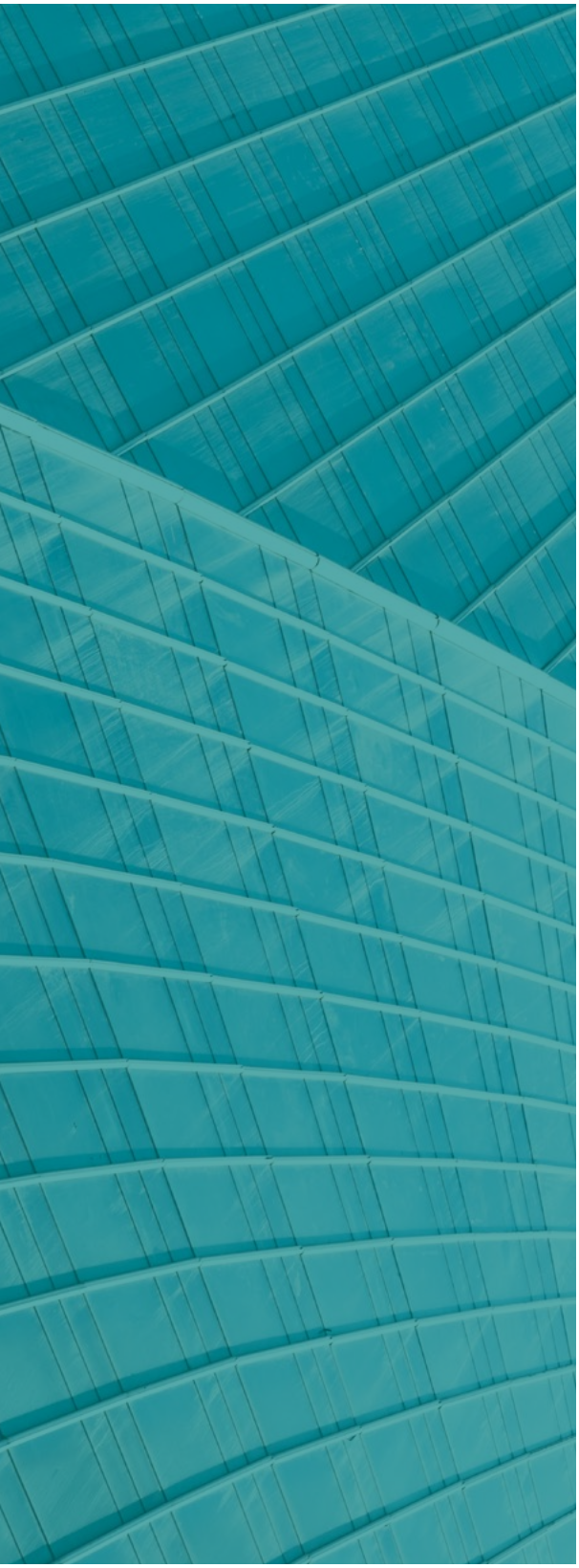
Defries then filed an individual lawsuit in the Oregon federal court. Union Pacific moved for

summary judgment, arguing that the statute of limitations had run on Defries's claims because *American Pipe* tolling for Defries had concluded upon the certification in *Harris* of a class that did not include him. Specifically, Union Pacific argued that failing a color-blindness exam was not a "reportable health event," and, thus, "the narrowed class definition certified by the Nebraska court had unambiguously excluded color-vision plaintiffs like Defries." The district court agreed with Union Pacific and granted summary judgment.

The Ninth Circuit held that absent (or bystander) members remain entitled to *American Pipe* tolling until a court accepts a revised class definition that unambiguously excludes them. The court reasoned that *American Pipe* serves to excuse those with potential claims from having to rush to court to preserve their rights, and instead encourages them to rely on the class adjudication without having to sift through ambiguities regarding class membership. Thus, the court held that, in order for *American Pipe* tolling to end upon the narrowing of a class, the exclusion of any given absent class member must be unambiguous, and ambiguity must be resolved in favor of absent class member. *Defries*, No. 3:21-cv-00205-SB, at *15.

The Ninth Circuit found that Defries's case was timely because a relevant ambiguity existed in the scope of the *Harris* class certification. The court observed that the district court had observed that color-vision testing was legally required routine testing rather than a "reportable health event." The Ninth Circuit disagreed, finding that the failure of a color-blindness test would probably be a reportable health event for a railroad company as an existing condition that could endanger others. Thus, "the revised definition was, at best, ambiguous with respect to plaintiffs like Defries." The court found that color-vision plaintiffs had not been unambiguously excluded from the *Harris* class until the class was decertified by the Eighth Circuit, and held that *American Pipe* tolling for color-vision bystander plaintiffs extended until the date of the Eighth Circuit's decision. *Id.*

Defries v. Union Pac. R.R. Co. is significant because it is the first time that the Ninth Circuit has addressed the "narrowed class" tolling issue. *Defries* aligns the Ninth Circuit with the Fourth and Tenth Circuits. *See Smith v. Pennington*, 352 F.3d 884, 892-96 (4th Cir. 2003); *Sawtell v. E.I. du Pont de Nemours & Co., Inc.*, 22 F.3d 248, 252-54 (10th Cir. 1994). Two months after the *Defries* decision, the Fifth Circuit aligned itself with *Defries* in another case against Union Pacific. *Zaragoza v. Union Pac. R.R. Co.*, 2024 U.S. App. LEXIS 20245, _F.4th_ (holding that *American Pipe* tolling has not ended because the class definition did not unambiguously exclude the plaintiff). With the ambiguity rule seemingly gaining momentum, defendants may find themselves wondering when, if ever, their exposure to the individual claims of class members actually ends, when a class has been narrowed during the course of litigation.



SIXTH CIRCUIT DECLINES INVITATION TO NARROW SCOPE OF FCRA PREEMPTION

Plaintiff McKenna, a truck driver, was employed by Defendant Dillon Transportation, LLC ("Dillon"). McKenna was involved in an accident and Dillon fired him. Dillon also submitted a Drive-A-Check ("DAC") report to a company called HireRight which report stated that McKenna was responsible for the accident. *McKenna v. Dillon Transp., LLC*, 97 F.4th 471 (6th Cir. 2024). Companies that employ truck drivers use HireRight's collection of DAC reports to perform background checks on potential hires. McKenna sued Dillon, asserting state defamation and tortious interference claims. The district court granted summary judgment in favor of Dillon, holding that the Fair Credit Reporting Act, 15 U.S.C. § 1681, *et seq* ("FCRA") preempted the plaintiff's defamation claim.

On appeal, the United States Court of Appeals for the Sixth Circuit considered whether the FCRA preempted McKenna's state law defamation claim (McKenna's tortious interference claim was abandoned at the district court level). The FCRA prohibits furnishing information relating to a consumer to any consumer reporting agency if the person knows or has reasonable cause to believe the information is inaccurate. *Id.* (citing 15 U.S.C. § 1681s-2(a)(1)(A)). The FCRA also expressly "preempts state causes of action based on providing information" to companies like HireRight. Moreover, the FCRA prohibits states from regulating the subject matter covered under § 1681s-2. *Id.* (citing 15 U.S.C. § 1681t(b)(1)(F)).

The Sixth Circuit previously held that the FCRA "preempts state common law claims involving a furnisher's reporting of information to consumer reporting agencies." *See Scott v. First S. Nat'l Bank*, 936 F.3d 509, 519 (6th Cir. 2019).

McKenna argued that FCRA preemption was in conflict with a decision Congress had made in a more specific context not to preempt state law. He argued that the Transportation Equity Act for the 21st Century (49 U.S.C. § 508 and 49 C.F.R. § 391.23, the implementing regulation), which specifically addresses motor carriers and safety performance records, is in conflict with the sweep of the FCRA's preemptive scope because § 508 does not limit liability for those "who knowingly furnish false information" and consequently, his defamation claim could proceed thereunder.

The Sixth Circuit held that, even if McKenna's suit could have proceeded if one considered only § 508, it was still barred by the FCRA's preemption provision. McKenna asserted that § 508 should control because § 508 is a "more specific statute." The court held that the FCRA preemption provision can coexist with § 508. The former prohibits states from regulating false

reports to consumer reporting agencies, whereas the latter bars specific claims against those who request or provide employment information. *Id.* Because the statutes "have different textual purposes and scopes," neither "swallows" the other.

FIFTH CIRCUIT HOLDS COLLECTORS TO STRICT ACCURACY IN CHARACTERIZING DEBTS

The Fifth Circuit recently made it clear that debt collectors will be held to high standards when characterizing debts they are trying to collect. *Calogero v. Shows, Cali & Walsh, LLP*, 95 F.4th 951 (5th Cir. 2024), concerns alleged debts owed by Louisiana disaster-recovery beneficiaries under the "Road Home" grant program, which was designed to provide funding for Louisiana homeowners' rebuilding efforts after Hurricane Katrina. Relevantly here, Road Home beneficiaries were contractually required to disclose previously received repair benefits from, for example, insurance providers or FEMA. Calogero received duplicative benefits prohibited by the Road Home agreements. A decade later, the State of Louisiana retained a law firm, Shows, Cali & Walsh ("SCW"), to help recover double payments made under the Road Home program. Calogero received a letter from SCW, threatening legal action unless repayment was made within 90 days.

Calogero brought suit against SCW, alleging that the dunning letter violated the Fair Debt Collection Practices Act ("FDCPA") because, *inter alia*, it mischaracterized the alleged debts, failed to itemize the alleged debts and was materially misleading. The FDCPA prohibits the use of any false, deceptive or misleading representation in connection with the collection of any debt and collectors may not misrepresent "the character, amount, or legal status of any debt." 15 U.S.C. § 1692e.

Calogero's letter asserted that she owed the state $4,598.89 in insurance proceeds; however, when pressed by Calogero's counsel, SCW changed course and alleged the debt was comprised of duplicative FEMA payments and a 30 percent penalty for not having flood insurance. Notably, the Road Home contracts did not include a flood insurance penalty. The district court held that itemization of debts was unnecessary in this case and that, in any event, the letter was not misleading because it accurately presented the total amount of debt owed. Calogero then appealed to the Fifth Circuit.

The Fifth Circuit reversed. Though the court declined to weigh in on whether SCW was required to itemize the alleged debts, it did hold that the letter was materially misleading. The court observed that representing to a consumer what a debt is for one thing, only to later change the characterization of the debt, is "plainly" a violation of the FDCPA.

The Fifth Circuit was unmoved by SCW's argument that the letter was not "misleading" under the FDCPA because the "final bottom line" number was accurate. The court held that a debt collector may not escape FDCPA liability when it demands payments on "imaginary debts," even if the bottom line figure is accurate. *Calogero* offers clear guidance to collectors that debts must be characterized accurately to avoid running afoul of the FDCPA.

SIXTH CIRCUIT PERMITS INTERLOCUTORY APPEAL OF CLASS CERTIFICATION UNDER RULE 23(F)

In *In re City of Cleveland*, 2024 U.S. App. LEXIS 11179 (6th Cir. May 7, 2024), the Sixth Circuit offered guidance on how to obtain interlocutory review of a class certification order under Fed. R. Civ. P. 23(f). Rule 23(f) gives appellate courts discretion to entertain interlocutory appeals of district court orders granting or denying class certification. Still, circuit courts—including the Sixth Circuit—have generally been reluctant to exercise that discretion. *See, e.g., In re Delta Airlines*, 310 F.3d 953, 959 (6th Cir. 2002) ("[T]he Rule 23(f) appeal is never to be routine.").[1] But the Sixth Circuit does often explain its decisions with respect to 23(f) applications, unlike most of its sister courts. It recently did so again, offering rare guidance to litigants aggrieved by trial court class certification decisions.

In *City of Cleveland*, customers of the City's Division of Water brought a putative class action against the City, alleging that the Water Division's billing and collections practices violated the federal Fair Housing Act and other state and federal law. *See Pickett v. City of Cleveland*, 2023 U.S. Dist. LEXIS 176393, at *3-4 (N.D. Ohio Sept. 30, 2023). The district court granted the plaintiffs' motion for class certification under Rule 23. The City requested interlocutory review under Rule 23(f).

The Sixth Circuit granted the City's request. *See City of Cleveland*, 2024 U.S. App. LEXIS 11179, at *6. In allowing the appeal, the court emphasized its unfettered discretion under Rule 23(f) to permit interlocutory review of class certification orders. *Id.* at *2. The court then delineated four factors affecting how the court exercises its discretion: 1) "whether the certification decision turns on a novel or unsettled question of law," 2) "whether the petitioner can demonstrate some likelihood of success in overturning the class certification decision," 3) "whether the decision amounts to a death knell—either because the stakes are too small to justify the costs of individual suits or because defending a class action is so costly that the defendant would be forced to settle," and 4) "the posture of the case as it is pending before the district court." *Id.* at *2-3 (citing *Delta Airlines*, 310 F.3d at 957-60).

The court found that each of these factors favored interlocutory review. As to the first factor, the court concluded that the suit involved a novel and unsettled question of law: whether the complained-of billing and collections practices could support a claim under the Fair Housing Act. *Id.* at *4. As to the second factor—some likelihood of success on the merits—the court reasoned the City sufficiently demonstrated that the certification order may have relied on an overbroad interpretation of the Fair Housing Act. *Id.* at *4-5. As to the third factor, the court underscored the vast effects of the district court's certification order; not only did it affect every water customer of the City by virtue of the present suit, but it also set a precedent for class certification against utilities across the country who used similar billing and collections methods. *Id.* at *6. Finally, the court concluded that the fourth factor warranted interlocutory review because class certification orders are "inherently tentative, particularly during the period before any notice is sent to members of the class." *Id.*

For those facing or prosecuting class actions, *City of Cleveland* offers a rare glimpse into the thinking of appellate courts on

[1] For a fulsome analysis on each circuit's approach to interlocutory appeals under Rule 23(f), see the Spring 2021 issue of The Brief.

when to accept interlocutory class certification appeals. Though the court did not modify its previous *Delta Airlines* guidance, the case does confirm that, especially in cases that may have widespread and profound effects, appellate courts (at least the Sixth Circuit) are willing to use Rule 23(f) interlocutory review to head off unwarranted disruptions.

SIXTH CIRCUIT PERMITS SOLICITATION OF MEMBERS OF PRELIMINARILY CERTIFIED CLASS

In 2023, Wayside Church and other named plaintiffs brought a putative class action in the US District Court for the Western District of Michigan against 43 Michigan counties, alleging the counties committed unconstitutional takings when they failed to refund to homeowners excess proceeds remaining after the counties foreclosed to satisfy tax debts (e.g., keeping $200,000 in sale proceeds, despite only a $17,000 tax debt being owed). Shortly after the lawsuit was filed, the parties moved for preliminary approval of a class settlement. A law firm, Visser and Associates ("Visser"), moved to intervene, arguing that the plaintiffs could not protect the interests of Visser's clients, who were pursuing similar individual takings claims against counties throughout Michigan. The district court denied this motion for leave to intervene. At the same time, Visser began sending solicitation letters to members of the putative class, including some of the named plaintiffs, encouraging them to engage Visser to bring takings claims on their behalf.

The court granted preliminary approval of the proposed settlement and conditionally certified a settlement class. The plaintiffs then moved for a protective order to bar Visser from continuing to send solicitation letters to members of the conditionally certified class. The plaintiffs' position was that the solicitation letters undermined the conditionally certified class and violated Michigan's Rule of Professional Conduct 4.2 by communicating with the already-represented members of the conditionally certified class. Visser agreed to stop sending the solicitation letters.

But Visser did not stop. At a show cause hearing, plaintiffs introduced a solicitation follow-up letter that Visser sent to a member of the conditionally certified class after Visser had told the court it would stop sending the letters. The district court entered a protective order barring Visser from continuing to communicate with potential class members. The court based its order on two grounds: (1) that Visser's solicitations threatened to undermine the proper administration of the class settlement and (2) that Visser's solicitations violated Rule 4.2 because they were purposefully directed at already-represented litigants. Visser appealed.

In *Wayside Church v. Van Buren Cnty., Mich.*, 103 F.4th 1215 (6th Cir. 2024), the Sixth Circuit affirmed, but disagreed with much of the district court's reasoning. The Sixth Circuit found first that Rule 23(e) preliminary approval does not create an actual certification sufficient to make all absent members of the conditionally certified class clients of class counsel. Thus, the district court erred when it determined that the putative class members were already represented by the named plaintiffs' counsel. Second, the court found it problematic to restrict Visser's communications in an attempt to avoid "undermining" the settlement agreement. After all, the court reasoned, some settlement agreements should be undermined; otherwise, there would be no way outside observers could alert class members that their attorneys were negotiating a favorable attorney's fee award at the expense of the class's actual recovery.

However, the Sixth Circuit did agree with the district court that Visser's communications with the named plaintiffs were unethical because the named plaintiffs were already represented. This, the Sixth Circuit found, was sufficient grounds to justify the protective order. The court also observed that Visser's lack of candor—continuing to send follow-up solicitations after saying it would cease doing so—further supported the entry of the protective order. Thus, the court affirmed the protective order, holding that the order appropriately prevented Visser's continued unethical conduct from threatening the fairness of the litigation process and the administration of justice generally.

Though the outcome of the appeal was not favorable to Visser, the Sixth Circuit's opinion is a win for firms that object to proposed class settlements in that it seems to greenlight the solicitation of absent class members after preliminary approval. Settling defendants should be wary and should consider employing "blow" clauses and other devices to ensure that claims thought resolved by the class settlement are actually resolved upon final approval.

THIRD CIRCUIT OVERRULES PRECEDENT, ADOPTS *DE NOVO* STANDARD OF REVIEW IN DEMAND FUTILITY DISMISSAL DECISIONS

In 2016 and 2017, Cognizant Technology Solutions Corporation ("Cognizant") disclosed a bribery scheme in which its overseas employees paid approximately $6 million in bribes to government officials, in violation of the Foreign Corrupt Practices Act ("FCPA"). After the SEC opened an investigation into Cognizant's compliance with the FCPA and Cognizant incurred over $60 million in investigative costs and paid $25 million in fines, shareholders filed suit against the board of directors. Plaintiffs alleged the director defendants knew of red flags with the compliance program but ignored the problems and hid concerns from shareholders. Defendants moved to dismiss the complaint on the basis that plaintiffs failed to make demand on Cognizant's board before filing suit. The district court dismissed the case, holding that the complaint failed to state with particularity the reasons why making demand on Cognizant's board would have been futile.

In a shareholder derivative suit, the plaintiff must either make a demand on the board to file the lawsuit itself or show that making such a demand would be futile. And Federal Rule of Civil Procedure 23.1 requires that derivative complaints allege with particularity that pre-suit demand

was made and refused by the board or the reasons for not making a demand.

In *Cognizant Technology Solutions Corporation*, 101 F.4th 250 (3d Cir. 2024), the *en banc* Third Circuit Court of Appeals overruled *Blasband v. Rales*, 971 F.2d 1034, a 1992 opinion which held that cases dismissed on the basis of demand futility should be reviewed under an abuse of discretion standard. Reasoning that *Blasband* lacked a rationale and relied upon a general practice of sister courts which had subsequently changed, the court joined several other circuits in adopting a *de novo* standard of review in demand futility cases. The court also noted the abuse of discretion standard was "unworkable in practice" and "flawed in conception" because whether demand is futile depends only upon whether plaintiff adequately pleaded state-law requirements.

Applying the *de novo* standard, the Third Circuit affirmed the dismissal, because plaintiffs failed to plead demand futility sufficiently. The court applied Delaware law to consider whether plaintiffs had alleged with particularity facts showing that demand would be futile. Under Delaware law, demand is futile if a majority of the directors who comprise the demand board (i) received a material personal benefit from the alleged misconduct that is the subject of the demand, (ii) faced a substantial likelihood of liability on any of the claims that would be the subject of the demand, or (iii) lacked independence from someone who received a material personal benefit from the alleged misconduct that would be the subject of the demand. If one of these questions is true for at least half of the demand board, demand is excused as futile. Plaintiffs argued that the director defendants faced a substantial likelihood of liability for breaching their fiduciary duty of loyalty and that three of the directors were not independent from the other directors who faced a substantial risk of liability.

In affirming the district court, the Third Circuit concluded that plaintiffs had not sufficiently alleged that any of the directors faced a substantial likelihood of liability. First, plaintiffs had not pled that the director defendants *knowingly* disclosed false information by informing shareholders that no incidents of corruption were reported for certain years while employees had been actively engaged in the bribery scheme. The court reasoned that though plaintiffs alleged the director defendants knew about gaps in the compliance scheme, plaintiffs did not allege they knew about the bribery. The court also rejected plaintiffs' argument that the director defendants engaged in corporate waste by paying themselves fees, compensation and benefits while violating their fiduciary duties, because plaintiffs had not alleged facts that defendants did nothing in return for their compensation.

Finally, the court concluded that plaintiffs' allegations that three directors were not independent were insufficient because plaintiffs would need to establish that six directors were not independent to satisfy Delaware law.

The *Cognizant* opinion aligns the Third Circuit with other circuit courts that have adopted the *de novo* standard for review of the dismissal of a derivative action for the failure to plead demand futility under Rule 23.1. *See City of Cambridge Retirement Sys. v. Ersek*, 921 F.3d 912, 917 (10th Cir. 2019); *Espinoza ex rel. JPMorgan Chase & Co. v. Dimon*, 797 F.3d 229, 235 (2d Cir. 2015); *Union de Empleados de Muelles de Puerto Rico PRSSA Welfare Plan v. UBS Fin. Servs. Inc. of Puerto Rico*, 704 F.3d 155, 162-163 (1st Cir. 2013); *Westmoreland Cty. Employee Retirement Sys. v. Parkinson*, 727 F.3d 719, 724 (7th Cir. 2013); *Gomes v. Am. Century Cos., Inc.*, 710 F.3d 811, 815 (8th Cir. 2013); *In re Ferro Corp. Derivative Litig.*, 511 F.3d 611, 617 (6th Cir. 2008).

CONTRIBUTORS

BRIAN V. OTERO
Co-Head, Financial Services Litigation
botero@HuntonAK.com
+1 212 309 1020

RYAN A. BECKER
Partner
rbecker@HuntonAK.com
+1 212 309 1055

MICHAEL B. KRUSE
Counsel
mkruse@HuntonAK.com
+1 212 309 1387

JENNIFER L. CLYDE
Associate
jclyde@HuntonAK.com
+1 214 979 2929

MAX DONALD
Associate
mdonald@HuntonAK.com
+1 713 220 3609

NIKITA KULKARNI
Associate
nkulkarni@HuntonAK.com
+1 212 309 1273

TOM SCHULTE
Associate
tschulte@HuntonAK.com
+1 305 810 2480

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