Simpson Thacher

Securities Law Alert

KEY DEVELOPMENT IN SHAREHOLDER LITIGATION

Ninth Circuit: Clarifies the Application of the *Larson* Test in Shareholder Derivative Actions

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On March 28, 2025, the Ninth Circuit affirmed a district court's dismissal of a shareholder derivative action brought by a venture capital firm (the "VC firm") against a technology manufacturer, on the ground that the VC firm could not fairly or adequately represent the interest of the manufacturer's stockholders. *Bigfoot Ventures Ltd. v. Knighton*, 2025 U.S. App. LEXIS 7218 (9th Cir. 2025) (Gould, J.). In its decision, the Ninth Circuit clarified the application of the eight-factor test established in *Larson v. Dumke*, 900 F.2d 1363 (9th Cir. 1990), which is used to assess the adequacy of representation by a plaintiff in a shareholder derivative action. The Ninth Circuit held that the district court did not err in considering the ongoing litigation between the VC firm and the manufacturer, pointing out that "[s]uch entanglements may make it likely that the interests of the other stockholders will be disregarded in the management of the suit."

Background and Procedural History

Between 2002 and 2005, the VC firm made several loans to the manufacturer through promissory notes that were secured by the manufacturer's patents. Subsequently, the VC firm sued the manufacturer in state court to collect on the notes, which had been restructured into one note. After that, there were several lawsuits between the VC firm and the manufacturer and its CEO/founder concerning the VC firm's investments in the manufacturer and the manufacturer's patents. In 2019, the VC firm brought the instant shareholder derivative action in federal district court alleging that an agreement transferring the manufacturer's inventory and revenue to an LLC that was formed by the CEO was not intended to benefit the manufacturer or its shareholders. The manufacturer moved to dismiss on the ground of plaintiff inadequacy under Federal Rule of Civil Procedure 23.1 ("FRCP 23.1"). The district court ordered supplemental briefing on whether the VC firm satisfied the test in *Larson v. Dumke*. In 2023, the district court dismissed concluding that the VC firm was inadequate to represent the manufacturer's shareholders.

The Ninth Circuit Broadens the Scope of What a Court May Consider in Analyzing Adequacy of Representation

The Ninth Circuit began by explaining that under FRCP 23.1(a), a "derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of shareholders or members who

are similarly situated in enforcing the right of the corporation or association." The Ninth Circuit stated that *Larson* identified eight factors for a court to consider in determining the adequacy of representation.[1] The Ninth Circuit then clarifying how the *Larson* factor test should be applied, explaining that "it is not mandatory for a court to assess each and every one of the *Larson* factors" and that "[c]ourts may consider other factors like outside entanglements[.]" Notably, the Ninth Circuit stated that "[c]ourts can consider whatever other factors help them to assess" plaintiff adequacy "in addition to the *Larson* factors."

The Ninth Circuit then held that the derivative action could not be maintained because the VC firm "does not fairly and adequately represent the interests of [the manufacturer's] shareholders." The Ninth Circuit further held that the district court did not err in considering the ongoing litigation between the VC firm and the manufacturer under "outside entanglements." The Ninth Circuit noted that there have been frequently litigated disputes between the VC firm and the manufacturer concerning the VC firm's investments in the manufacturer and the ownership and use of the patents. The Ninth Circuit concluded that due to their "consistently contentious nature," the lawsuits are "significant outside entanglements, making it probable that the interests of [the manufacturer's] stockholders will be disregarded[.]" The Ninth Circuit noted that the district court's conclusion that derivative action appears to be leverage in the VC firm's other lawsuits "weighs heavily against plaintiff's adequacy."

As to the *Larson* factors themselves, the Ninth Circuit concluded that they "also support the district court's finding of plaintiff inadequacy" and that the district court correctly found four *Larson* factors weighed against plaintiff adequacy. First, the Ninth Circuit stated that there were indications that the VC firm was the true party in interest but as a separate entity and not as a manufacturer shareholder because the VC firm was seeking to use the derivative action to advance its own separate interests (namely, as another attempt to collect on a 2017 state court judgment awarding it $8 million and to take ownership of the manufacturer's patents). Second, the Ninth Circuit stated that the VC firm's personal interest in gaining control of the patents was greater than its interest in asserting rights on behalf of the manufacturer. Third, the Ninth Circuit stated that nothing indicated that the manufacturer's shareholders support this derivative action. The Ninth Circuit noted that "[t]o the contrary, three shareholders submitted declarations that formally and emphatically object to [the] derivative action." Fourth, the Ninth Circuit stated that the lengthy history of litigation supported the district court's finding that the VC firm was "vindictive" toward the manufacturer and its CEO.

[1] The eight *Larson* factors are: "(1) indications that the plaintiff is not the true party in interest; (2) the plaintiff's unfamiliarity with the litigation and unwillingness to learn about the suit; (3) the degree of control exercised by the attorneys over the litigation; (4) the degree of support received by the plaintiff from other shareholders; (5) the lack of any personal commitment to the action on the part of the representative plaintiff; (6) the remedy sought by plaintiff in the derivative action; (7) the relative magnitude of plaintiff's personal interests as compared to his interest in the derivative action itself; and (8) plaintiff's vindictiveness toward the defendants."

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