Practical Implications Of Delaware's New Demand-Futility Test

By **Courtney Worcester and Roger Lane** (October 13, 2021)

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In a decision that provides valuable clarity to an important aspect of Delaware corporate law, the Delaware Supreme Court has announced a new three-part test as the "universal test for assessing whether demand should be excused as futile" when stockholders seek to bring derivative litigation on a company's behalf.

In its Sept. 23 decision in United Food and Commercial Workers Union v. Zuckerberg, the court blended and refined the two traditional demand-futility tests the Delaware Supreme Court established in its 1984 decision in Aronson v. Lewis[1] and its 1993 decision in Rales v. Blasband,[2] which together had governed this subject for nearly 30 years.

While describing the new test as being consistent in principle with prior demand-futility decisions, aspects of the court's decision will, as a practical matter, close off certain paths for plaintiffs who seek to plead demand futility — including by:

- Clarifying that exculpated duty of care claims do not excuse demand;
- Drawing a clear distinction between the test for demand futility and the underlying standard of judicial review applicable to a challenged decision or transaction; and
- Making clear that a conflicted-controller transaction does not, ipso facto, result in a finding of demand futility.

Background

The underlying case involved the fallout from challenges to a 2016 decision by the board of directors of Facebook to approve a stock reclassification that would allow Facebook Chairman and CEO Mark Zuckerberg to sell most of his Facebook stock while maintaining voting control of the company.

After its approval, more than a dozen complaints were filed challenging the plan, claiming that the board violated its fiduciary duties by negotiating and approving a purportedly one-sided deal that put Zuckerberg's interests ahead of those of Facebook. These cases were consolidated into one class action but, shortly before trial, Zuckerberg requested that the reclassification be withdrawn, which mooted the consolidated class action.

Another stockholder then brought a derivative suit after the class action had settled, essentially seeking to recoup the more than $80 million in attorney fees that Facebook had either paid to plaintiffs counsel to settle that case, or had spent on its own defense.

Before bringing suit, the stockholder did not make a demand under Delaware Court of Chancery Rule 23.1. Instead, the plaintiff alleged that demand was futile because the defendants breached their duty of care in negotiating and approving the reclassification.

Both the plaintiff and defendants agreed that the Aronson test applied because the complaint challenged a decision made by the same majority of directors that would consider the litigation demand. In such circumstances, demand is excused as futile under Aronson if the complaint alleges particularized facts that raise a reasonable doubt that (1) a majority of the directors are disinterested and independent, or (2) the challenged transaction was otherwise the product of a valid business judgment.

The Court of Chancery dismissed the complaint, holding that demand was not excused, and in so doing the Court of Chancery articulated a new three-part test for demand futility that was meant to apply in all circumstances, and that "treated Rales as the general demand futility test," and treated Aronson as "a special application of the Rales test."

The plaintiff appealed, arguing that the new test improperly applied the second prong of Aronson, and that the relevant question was whether "the challenged transaction was ... the product of a valid business judgment," regardless of whether the directors faced substantial liability.

Adoption of Universal Three-Part Demand-Futility Test

On appeal, the Supreme Court agreed with the Court of Chancery that it was time "to move on from Aronson entirely." It unanimously adopted the Court of Chancery's three-part test, combining elements of both Rales and Aronson in a universal test for demand futility.

Thus, going forward, courts should ask the following three questions on a director-by-director basis when evaluating allegations of demand futility:

1. Whether the director received a material personal benefit from the alleged misconduct that is the subject of the litigation demand;

2. Whether the director faces a substantial likelihood of liability on any of the claims that would be the subject of the litigation demand; and

3. Whether the director lacks independence from someone who received a material personal benefit from the alleged misconduct that would be the subject of the litigation demand or who would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand.

If the answer to any of the questions is "yes" for at least half of the members of the demand board, then demand is excused as futile.

In reaching its decision, the Supreme Court underscored on more than one occasion the primacy that Delaware law accords to board control over corporate affairs, including corporate legal claims and the decision whether to pursue them, as well as the fact that stockholder derivative suits represent an effort to displace that primary authority.

The court stated:

> The purpose of the demand-futility analysis is to assess whether the board should be deprived of its decision-making authority because there is reason to doubt that the directors would be able to bring their impartial business judgment to bear on a litigation demand. That is a different consideration than whether the derivative claim

> is strong or weak because the challenged transaction is likely to pass or fail the applicable standard of review. It is helpful to keep those inquiries separate.

In so doing, the Supreme Court also reinforced its long-standing aversion to second-guessing the substance of business decisions made by corporate directors, reinforcing its focus on whether directors are able to exercise independent and disinterested judgment in assessing matters that are brought before them for decision.

Practical Implications

The recasting of Aronson's second prong to focus on whether a director faces a substantial likelihood of liability on a proposed derivative claim — as opposed to focusing on the applicable standard of review for the claim (e.g., entire fairness versus business judgment rule), or the strength or weakness of the claim — clarifies an important point on which Delaware authority was not entirely uniform.

As a practical matter, it does so in a way that enables directors to assess, more accurately and with greater confidence, when demand-futility allegations will fall short and expose a derivative action to early dismissal. This is a critical tool not only in assessing the viability of a derivative action that has been filed, but also in assessing the risk for such litigation far earlier, when a transaction is being structured and negotiated.

At bottom, unless a complaint alleges particularized facts sufficient to show that, going director-by-director, a majority of the board (1) received a material benefit in the challenged transaction or decision; or (2) utterly abdicated its duties in considering the transaction; or (3) lacks independence from directors subject to either or both of the foregoing infirmities, a claim of demand futility will be difficult to sustain.

Demand Futility Based on Duty of Care Claims Eliminated

Building on the Delaware Supreme Court's 2015 decision in In re: Cornerstone Therapeutics Inc. Stockholder Litigation,[3] United Food reinforces that if a corporation has adopted a Section 102(b)(7) exculpatory provision, directors face no risk of personal, monetary liability for duty of care claims.

Consequently, they cannot face a "substantial likelihood of liability on such claims" for demand-futility purposes, no matter how strong the duty of care claims may be. Demand therefore will not be excused under the second prong of United Food when only duty of care claims are asserted.

Importance of Pleading Non-Exculpated Claims to Establish Demand Futility

In the presence of a Section 102(b)(7) provision, a plaintiff seeking to establish demand futility with respect to one or more directors under the second prong of United Food will need to assert a non-exculpated breach of fiduciary duty claim against those directors; i.e., a claim for breach of the duty of loyalty.

Duty of loyalty claims can encompass, in addition to conventional self-dealing and participation in conflicted transactions, oversight claims[4] under the Chancery's 1996 In re: Caremark International Inc. Derivative Litigation decision, claims of corporate waste and claims of bad faith misconduct. What will not suffice are claims alleging a want of care, even if the conduct at issue rises to the level of gross negligence.

While waste claims have long been disfavored in Delaware, and Caremark claims remain a difficult theory upon which a plaintiff can hope to prevail — acknowledging that some have recently survived the pleading stage — one can reasonably expect that United Food will incentivize plaintiffs to seek to develop derivative claims that assert a breach of the duty of loyalty, or that elevate due care claims to the level of a bad faith abdication of duty.

The Standard of Review Is Irrelevant, Even for Conflicted-Controller Transactions

United Food makes clear that simply because a challenged transaction is or may be subject to review under the entire fairness standard, that alone is insufficient to excuse demand under the second prong of the universal United Food test.

One consequence of this — addressed in United Food itself — is that demand will not be excused merely because a controlling stockholder stands on both sides of a challenged transaction.

Instead of focusing on the nature of the challenged transaction, United Food requires a steadfast focus on the individual directors themselves, and whether a majority of them received a material personal benefit as a result of the challenged transaction; face a substantial risk of personal liability on the claims asserted; or lack independence from another director who rings either or both of those bells.

Absent a pleading that sets out particularized facts sufficient to call into question the impartiality of a majority of the board on this basis, demand will not be excused.

Implications for LLCs

In the limited liability company context, the Delaware courts frequently look to the corporate law for guidance, particularly for principles of background law. As a result, the universal demand test announced in United Food may well be applied in the LLC context in due course.

Because LLCs are also creatures of contract, their operating agreements can expand, limit or even eliminate the fiduciary duties owed by managers, directors and others, including the duty of loyalty, and they can also limit or eliminate liability for any such violations.

If an LLC operating agreement eliminates all fiduciary duties or the associated monetary liabilities, or both, a plaintiff will be severely challenged to adequately allege demand futility, because the only limiting legal principle that cannot be disclaimed in the LLC context is the implied covenant of good faith and fair dealing, which provides only the slimmest of reeds to allege a substantial risk of fiduciary liability.

By the same token, if the operating agreement fails to eliminate liability for fiduciary duties and, in particular, liability for duty of care claims, then the types of claims that may subject a director to substantial liability will be broader than those that are now typical in the corporate context, and demand futility will, correspondingly, be that much easier to plead.

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[1] Aronson v. Lewis, 473 A.2d 805 (Del. 1984).

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

[3] In re Cornerstone Therapeutics, Inc. Stockholder Litigation, 115 A.3d 1173 (Del. 2015).

[4] In re Caremark International Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996).