November 3, 2020

Delaware Court of Chancery Provides New Guidance on the Standard for Analyzing Demand Futility

In an opinion that portends a potential shift in the standard applicable to motions to dismiss derivative cases for failure to plead demand futility—the more common basis for seeking dismissal of such cases in Delaware—Vice Chancellor J. Travis Laster recently eschewed a long-standing governing test for such motions in favor of a more flexible director-by-director analysis.

In *United Food & Comm. Workers Union v. Zuckerberg et al.*,[1] Vice Chancellor Laster dismissed a stockholder derivative suit against directors of Facebook, Inc. The court held that the plaintiff, who failed to make a pre-suit demand on Facebook's board, had not adequately pleaded that a majority of directors were incapable of exercising independent judgment in responding to a demand. Rather than apply the long-standing demand futility test set forth in *Aronson* v. *Lewis*[2]—which requires the court to consider not only director independence and disinterestedness but also whether the challenged board decision was a valid exercise of business judgment—the court instead examined the allegations concerning each director to determine whether a majority of directors were improperly conflicted or had acted in bad faith. The opinion echoes growing skepticism, both by commentators and in dicta in judicial opinions, that the *Aronson* test is no longer viable, and is the first to expressly decline to apply *Aronson* because its "analytical framework is not up to the task."[3] It remains to be seen whether the issue will be taken up by the Delaware Supreme Court, which first announced the *Aronson* test more than 35 years ago.

Background: The Two Tests for Determining Demand Futility under Delaware Law

A fundamental principle of Delaware law is that a corporation's board of directors—not its stockholders—is charged with managing the business and affairs of the corporation, including the initiation of litigation on the corporation's behalf. Accordingly, under Court of Chancery Rule 23.1, a stockholder may pursue a derivative suit on behalf of a corporation only if the stockholder first (a) makes a demand on the board to pursue litigation that is wrongfully refused, or (b) demonstrates that making such a demand would have been futile because a majority of the board was not capable of making an impartial decision regarding the litigation. The Delaware Supreme Court has established two tests for determining whether directors can exercise independent and disinterested judgment regarding a demand. The *Aronson* test applies in

1 C.A. No. 2018-0671-JTL (Del. Ch. Oct. 26, 2020).

2 473 A.2d 805, 814–15 (Del. 1984).

3 *Zuckerberg*, slip op. at 42.

situations when the directors who made the challenged decision also constitute a majority of the directors who would consider a pre-suit litigation demand. *Aronson* requires plaintiffs to plead particularized facts that create a reasonable doubt that (i) a majority of directors are disinterested and independent as relates to the challenged decision, or (ii) the challenged decision "was otherwise the product of a valid exercise of business judgment." The *Aronson* test thus focuses on the substance of the challenged transaction.

Nine years after *Aronson*, the Delaware Supreme Court announced a different test in *Rales* v. *Blasband*,[4] which applies when no specific board decision is challenged (for example, for claims alleging a failure of board oversight), or when a majority of the directors on the board considering the litigation demand did not participate in the challenged decision. The *Rales* test requires plaintiffs to plead particularized facts that create a reasonable doubt that, "as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to the demand."[5] *Rales* thus focuses the inquiry on the independence of the decision regarding a litigation demand rather than the underlying business decision being challenged.

The *Aronson* test, which was first announced in 1984, analyzes whether directors face a substantial likelihood of liability (and therefore cannot consider a demand) based, in part, on the standard of review that applies to the challenged transaction. That is, the test first examines the directors' independence and disinterestedness with respect to the challenged transaction. If a disinterested and independent majority of directors approved the challenged transaction, then the directors are deemed disinterested concerning the litigation demand; conversely, if a majority of the board is interested in the underlying transaction or lacks independence, then demand is excused as futile. There is also a so-called "second prong" of the *Aronson* test, that considers whether—even where a disinterested and independent majority of the board makes the decision in question—there is reason to doubt that the challenged transaction was the product of a valid exercise of business judgment. *Aronson* thus assumes that "in rare cases, a transaction may be so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists."[6]

Subsequent developments have undermined *Aronson*'s central premise. Most critically, the *Aronson* test predated the enactment of Section 102(b)(7) of the Delaware General Corporation Law, which allows corporations to adopt charter provisions (which have since become ubiquitous) shielding directors from personal liability for money damages unless, among other things, they breached their fiduciary duty of loyalty by engaging in self-dealing or acting in bad faith. Under current Delaware law, a plaintiff seeking to show that an exculpated director faces a substantial likelihood of liability for having approved a transaction must plead particularized facts providing a reason to believe that the director was self-interested, beholden

4 634 A.2d 927, 934 (Del. 1993).

5 *Id.*

6 *Aronson*, 473 A.2d at 815.

to an interested party, or acted in bad faith—no matter what standard of review applies.[7] This had led some courts and commentators to suggest that *Aronson's* focus on the applicable standard of review is outdated, and, as a result, that courts analyzing demand futility should default to the "more generally applicable and consistently relevant test set forth in *Rales*."[8]

The *Zuckerberg* Decision and New Guidance on the Demand Futility Test

Zuckerberg concerned Facebook's pursuit of a proposed reclassification of Facebook shares. Shortly after Facebook's board approved the reclassification proposal, it was challenged in a different lawsuit by Facebook stockholders. Five days before trial was set to begin, the board withdrew the proposal. In the *Zuckerberg* action, a stockholder alleged that Zuckerberg and the board members who initially approved the reclassification breached their fiduciary duties. Facebook and all defendants moved to dismiss the suit under Court of Chancery Rule 23.1 on the basis that plaintiff failed to make a demand on the board or adequately allege demand futility. A narrow majority of the board members who would have considered a demand also made the challenged decision to pursue the stock reclassification.

Vice Chancellor Laster acknowledged that, under a strict reading of Delaware Supreme Court precedent, the *Aronson* test applied in the *Zuckerberg* action because a majority of the board that would evaluate a demand served at the time the board approved the underlying reclassification. After carefully tracing the history of the *Aronson* test and subsequent developments, however, Vice Chancellor Laster determined that "its analytical framework is not up to the task," and instead chose to apply the *Rales* test while also "draw[ing] upon *Aronson*-like principles."[9] This is consistent with Vice Chancellor Laster's previous observations that "*Aronson* and *Rales* both ultimately focus on the same inquiry, i.e., whether 'the derivative plaintiff has shown some reason to doubt that the board will exercise its discretion impartially and in good faith.'"[10]

The court then proceeded to analyze demand futility on a director-by-director basis by considering "(i) whether the director received a material personal benefit from the alleged misconduct that is the subject of the litigation demand, (ii) whether the director would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand, and (iii) whether the director lacks independence from someone who received a material personal benefit from the alleged misconduct that is the subject of the

---

7 *See In re Cornerstone Therapeutics Inc. S'holder Litig.*, 115 A.3d 1173, 1179–80 (Del. 2015).

8 Donald J. Wolfe, Jr. & Michael A. Pittenger, *Corporate and Commercial Practice in the Delaware Court of Chancery* § 11.03[c][4][ii], at 11-113 (2019).

9 *Zuckerberg*, slip op. at 42.

10 *Hughes* v. *Hu*, C.A. No. 2019-112-JTL, 2020 WL 1987029, at *12 (Del. Ch. Apr. 27, 2020) (quoting *In re INFOUSA, Inc. Shareholders Litig.* 953 A.2d 963, 986 (Del. Ch. Ct. 2007)).

litigation demand or who would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand."[11]

As part of the "substantial likelihood of liability" analysis, the court considered both the operative standard of review, as required under *Aronson*, and the potential availability of exculpation, including whether the complaint raised a reasonable inference that a director acted in bad faith. After explaining this test, the Vice Chancellor applied it to the director defendants and granted their motion to dismiss under Court of Chancery Rule 23.1, concluding that "[a] majority of the Demand Board is disinterested, independent, and capable of considering a demand."[12]

Impact of the Decision in *Zuckerberg*

Vice Chancellor Laster's decision is not the first to suggest that "*Aronson* is broken,"[13] but it is the first to expressly apply a modified form of the *Rales* test in a situation where Delaware Supreme Court precedent would appear to mandate the application of *Aronson*. The analytical framework used to evaluate demand futility in *Zuckerberg* incorporates principles from both the *Aronson* and *Rales* tests and applies them in a single, flexible test that focuses primarily on the litigation demand rather than the decision being challenged. The change is welcome news for directors, particularly those serving on corporations that have adopted a Section 102(b)(7) exculpatory charter provision, who should benefit from having the test refocused on their independence and brought into line with modern Delaware law. It remains to be seen whether other members of the Delaware Court of Chancery will adopt Vice Chancellor Laster's test, and whether the Delaware Supreme Court will consider the issue on appeal and—if so—accept Vice Chancellor Laster's invitation to "move on from *Aronson* entirely."[14]

* * *

[11] *Zuckerberg*, slip op. at 42.

[12] *Id.* at 63.

[13] *Id.* at 40.

[14] *Id.* at 41.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Susanna M. Buergel
+1-212-373-3553
sbuergel@paulweiss.com

Andrew J. Ehrlich
+1-212-373-3166
aehrlich@paulweiss.com

Brad S. Karp
+1-212-373-3316
bkarp@paulweiss.com

Daniel J. Kramer
+1-212-373-3020
dkramer@paulweiss.com

Jane B. O'Brien
+1-202-223-7327
jobrien@paulweiss.com

Richard A. Rosen
+1-212-373-3305
rrosen@paulweiss.com

Audra J. Soloway
+1-212-373-3289
asoloway@paulweiss.com

Daniel Mason
+1-302-655-4425
dmason@paulweiss.com

Securities Litigation & Enforcement Practice Management Associate Daniel S. Sinnreich and Associates Matthew D. Stachel and Eliza Strong contributed to this Client Alert.