

# DELAWARE SUPREME COURT ADOPTS A NEW "UNIVERSAL" TEST FOR ESTABLISHING DEMAND FUTILITY GRANTING DIRECTORS GREATER PROTECTION AGAINST DERIVATIVE SUITS

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The Supreme Court of Delaware recently adopted a new three-part “universal” test to determine whether pre-suit demand upon a company’s board should be excused as futile. The new test, endorsed by the Court in *United Food and Commercial Workers Union and Participating Food Industry Employers Tri-State Pension Fund v. Zuckerberg*, may make it easier for boards of directors to obtain dismissal of putative stockholder derivative suits on a motion to dismiss. In adopting the new test, the Court also reaffirmed its commitment to the “cardinal precept” of Delaware law, which posits that absent extraordinary circumstances, directors, rather than stockholders, should control a company’s litigation decisions.

This decision arose from the decision by the board of directors of Facebook, Inc. (Facebook) to approve a stock reclassification that allowed Mark Zuckerberg, Facebook’s controller, chairman, and chief executive officer, to sell most of his Facebook stock while maintaining voting control of the company. Shortly thereafter, a number of stockholders filed class action lawsuits in the Delaware Court of Chancery challenging the reclassification. The suits were consolidated into a single action which was mooted shortly before trial when Facebook abandoned the reclassification. Facebook spent more than US\$21 million in defense of the consolidated litigation, and paid counsel for the plaintiffs more than US\$68 million in attorneys’ fees pursuant to the corporate benefit doctrine.

United Food and Commercial Workers Union and Commercial Workers Union and Participating Food Industry Employers Tri-State Pension Fund (Tri-State), then brought this derivative action, seeking to recoup the approximately US\$90 million Facebook had spent in connection with the prior class action. Tri-State’s complaint named as defendants Mr. Zuckerberg and five other individuals who served on Facebook’s board at the time the reclassification was approved. (At the time Tri-State filed its complaint, the board included the six defendants as well as three directors who joined the board after the reclassification was approved.)

Rather than making a pre-suit demand on the board under Court of Chancery Rule 23.1, Tri-State alleged that demand was excused as futile because, among other things, (i) the board’s negotiation and approval of the reclassification was not a valid exercise of its business judgment and (ii) a majority of the Facebook directors lacked independence from Mr. Zuckerberg.

Facebook and the defendants moved to dismiss the complaint, arguing that Tri-State did not adequately allege that demand was futile under *Aronson v. Lewis*<sup>1</sup>.

## THE ARONSON AND RALES TESTS FOR DEMAND FUTILITY

In order for a stockholder to bring a derivative claim (i.e., an action asserted on behalf of the corporation), the stockholder must either make a demand on the company's board of directors or allege particularized facts establishing that demand would be futile. As the Delaware Supreme Court explained in *Tri-State*, “[t]he 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.”

Prior to *Tri-State*, the Delaware Supreme Court had established two tests to determine whether a pre-suit demand should be excused as futile: the *Aronson* test<sup>2</sup> and the *Rales* test.<sup>3</sup>

The *Aronson* test was applied when the litigation challenged a decision by the same board that would be charged with considering a pre-suit demand. Under *Aronson*'s two-part test, a pre-suit demand was excused if the complaint alleged facts with particularity which raised a reasonable doubt that either the directors are disinterested and independent, or the challenged transaction was otherwise the product of valid business judgment.

The *Rales* test was applied in all other circumstances. Under *Rales*, demand is excused as futile if the complaint alleged particularized facts creating a reasonable doubt that, as of the time the complaint was filed, a majority of the board could have properly exercised independent and disinterested business judgment in responding to the demand. As the Supreme Court observed in *Tri-State*, “the broader reasoning of *Rales* encompasses *Aronson*, and therefore the *Aronson* test is best understood as a special application of the *Rales* test.”

Section 102(b)(7) of the General Corporation Law of the State of Delaware (Section 102(b)(7)) was enacted shortly after *Aronson* was decided. Section 102(b)(7) permits Delaware corporations to adopt a corporate charter provision which exculpates directors from monetary liability for breaches of the duty of care. Before the enactment of Section 102(b)(7), “rebutting the business judgment rule through allegations of care violations exposed directors to a substantial likelihood of liability” which could prevent them from independently and disinterestedly responding to a demand. Following the adoption of Section 102(b)(7), some courts struggled with the question of whether a claim for breach of the duty of care could satisfy the second prong of the *Aronson* test. The *Tri-State* decision resolves that question by holding that allegations that a director breached his or her duty of care cannot establish demand futility where a director is protected by a Section 102(b)(7) provision, and consolidates the *Aronson* and *Rales* tests into a single test of universal application.

## THE UNIVERSAL TRI-STATE TEST FOR DEMAND FUTILITY

The Court of Chancery dismissed the *Tri-State* action pursuant to Court of Chancery Rule 23.1 for failure to adequately allege facts establishing demand futility. In reaching this result, the court combined elements of the *Aronson* and *Rales* tests to create a hybridized three-part test to determine whether pre-suit demand is excused. The Delaware Supreme Court affirmed the Court of Chancery's ruling and formally adopted “as the universal test for assessing whether demand should be excused as futile” the same three-part test used by the lower court. Under the *Tri-State* test, courts should evaluate the following three questions on a director-by-director basis:

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 board who would be considering the demand, demand is excused as futile. The Delaware Supreme Court stressed that the new test “is consistent with and enhances *Aronson*, *Rales* and their progeny” and thus “cases properly applying those holdings remain good law.”

To the extent there was any confusion previously, the Delaware Supreme Court clarified that the first prong of *Aronson*, which is now the first prong of *Tri-State*, considers whether the directors had a “personal financial benefit from the challenged transaction that is not equally shared by the stockholders,” which is different from the consideration as to whether the directors face a substantial likelihood of liability for approving the challenged transaction.

Importantly, the Delaware Supreme Court also held that exculpated duty of care claims do not satisfy the second prong of *Aronson*, and cannot give rise to a substantial likelihood of liability for purposes of the universal test adopted by the Court in *Tri-State*.

Finally, the Court emphasized that the demand futility inquiry is analytically distinct from an inquiry into the propriety of the underlying transaction being challenged, and thus should be conducted without reference to the standard of review applicable to the transaction. The Court explained that the question addressed by the demand futility test -- “whether the board should be stripped 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” -- 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.”

Applying the new three-part test to the *Tri-State* complaint on a director-by-director basis, the Delaware Supreme Court held the complaint failed to allege that pre-suit demand should be excused as futile and concluded that the Court of Chancery properly dismissed *Tri-State*'s complaint for failing to make a demand on the board.

Delaware Courts of Chancery have already begun applying the *Tri-State* test to pending derivative lawsuits. See *Genworth Financial, Inc. Consolidated Derivative Litigation*, C.A. No. 11901-VCS, 2021 WL 4452338, at \*16 (Del. Ch. 29 Sept., 2021) (dismissing derivative lawsuit and noting that the *Tri-State* test resolved prior conflicting authority on whether purposeful inaction by a board was analyzed under the *Aronson* or *Rales* framework).

## FOOTNOTES

<sup>1</sup> 473 A.2d 805 (Del. 1984).

<sup>2</sup> *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984).

<sup>3</sup> *Rales v. Blasband*, 634 A.2d 927, 934 (Del. 1993).

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