

## Delaware Supreme Court: Adopts Three-Part Demand Futility Test; Agrees That Exculpated Claims Do Not Excuse Demand as They Do Not Expose Directors to a Substantial Likelihood of Liability

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On September 23, 2021, the Delaware Supreme Court affirmed a decision dismissing a derivative complaint for failing to make a demand on the board of a social media company under Court of Chancery Rule 23.1. [UFCW Union & Participating Food Indus. Emps. Tri-State Pension Fund v. Zuckerberg](#), 2021 WL 4344361 (Del. 2021) (Montgomery-Reeves, J.). Notably, the court adopted the Court of Chancery's three-part test for demand futility blending the tests from *Aronson v. Lewis*<sup>[1]</sup> and *Rales v. Blasband*.<sup>[2]</sup> Agreeing with the lower court, the court held that exculpated care claims do not excuse demand under *Aronson*'s second prong because they do not expose directors to a substantial likelihood of liability. The court also determined that plaintiff did not plead with particularity that a majority of the demand board lacked independence.

### Background

Plaintiff stockholder filed a derivative complaint in the Court of Chancery seeking compensation for the money the defendant social media company had spent in a prior class action. Plaintiff alleged that the company's directors breached their duty of care by negotiating and approving a purportedly one-sided stock reclassification that had been proposed by the company's CEO/controller/chairman. In this case, plaintiff did not make a litigation demand, pleading that demand was futile because the board's negotiation and approval of the stock reclassification was not a valid exercise of its business judgment and because a majority of the directors lacked independence from the company's CEO. The company and the other defendants moved to dismiss the complaint under Court of Chancery Rule 23.1 arguing that plaintiff did not make demand or prove that demand was futile. Plaintiff appealed the Court of Chancery's judgment dismissing the complaint under Rule 23.1.

### Exculpated Care Violations Do Not Satisfy Aronson's Second Prong

The court pointed out that the company's charter contained a Section 102(b)(7)<sup>[3]</sup> clause, therefore, the directors faced no risk of personal liability from plaintiff's allegations. Under these circumstances the issue was whether a derivative plaintiff can rely on exculpated care

violations to establish that demand was futile under *Aronson*’s second prong. The court affirmed the Court of Chancery’s holding that exculpated care claims do not satisfy *Aronson*’s second prong. The court explained that when *Aronson* was decided, rebutting the business judgment rule through allegations of duty of care violations exposed directors to a substantial likelihood of liability and raised doubt as to whether they could impartially consider demand. However, due to the enactment of Section 102(b)(7) and other corporate law developments since *Aronson*, exculpated breach of care claims no longer pose a threat that neutralizes director discretion.

***The Court Adopts the Court of Chancery’s Three-Part Test as the Universal Test for Demand Futility***

In support of its adoption of the Court of Chancery’s test, the court explained that “[b]lending the *Aronson* test with the *Rales* test is appropriate because both address the same question of whether the board can exercise its business judgment on the corporation’s behalf in considering demand; and the refined test does not change the result of demand-futility analysis.” The court clarified that 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.” The court observed that this is a different consideration than whether the challenged transaction is likely to pass or fail the applicable standard of review.

Going forward, under the refined test, “courts should ask the following three questions on a director-by-director basis when evaluating allegations of demand futility: (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 faces a substantial likelihood of liability on any of the claims that would be 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 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.”

As to the impact of the test, the court stated that “because the three-part test is consistent with and enhances *Aronson*, *Rales*, and their progeny, the Court need not overrule *Aronson* to adopt this refined test, and cases properly construing *Aronson*, *Rales*, and their progeny remain good law.”

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- [1] “Under *Aronson*, demand is excused as futile if the complaint alleges particularized facts that raise a reasonable doubt that (1) the directors are disinterested and independent, or (2) the challenged transaction was otherwise the product of a valid business judgment.”
- [2] “Under *Rales*, demand is excused as futile if the complaint alleges particularized facts creating a reasonable doubt that, as of the time the complaint is filed, a majority of the demand board could have properly exercised its independent and disinterested business judgment in responding to a demand.”
- [3] Section 102(b)(7) of the Delaware General Corporation Law “authorizes corporations to adopt a charter provision insulating directors from liability for breaching their duty of care.”

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