

Delaware Clarifies Its Rules Governing Stockholder Derivative Actions

WRITTEN BY

Stanley Keller

Derivative actions play an important role in policing corporate insider conduct and compliance by directors and controlling stockholders with their fiduciary duties. A derivative action enables a stockholder, upon satisfaction of applicable requirements, to bring litigation on behalf of the corporation challenging, for example, conflict of interest transactions, the adequacy of consideration in a merger or the board's attention to the corporation's legal compliance. In Delaware and several other states, before a stockholder may bring a derivative action it must make a demand on the board in order to give the board, as part of its responsibility to manage the affairs of the corporation, an opportunity to decide whether the demanded litigation is in the best interests of the corporation, unless, importantly, demand is excused because it would be futile due to the interests of a majority of the board in the matter. If demand is excused, the demanding stockholder can proceed with the derivative action; if demand is required, the court will then review the reasonableness of a board's decision not to pursue the matter. Other states, like the approach of the Model Business Corporation Act (the "MBCA"), require a demand in all cases (a so-called "universal demand"), leaving it to the court in reviewing the board's decision how to deal with the demanded litigation to factor in the independence and disinterestedness of the directors in connection with the court's evaluating the board's conduct and decision-making.

Unlike many states, whose corporate statutes (often modeled on the MBCA) deal with derivative proceedings, Delaware's law regarding derivative actions is judicially made, either through case law or court rules. The Delaware courts recently addressed several issues related to derivative actions, in some cases clarifying existing rules or establishing new rules.

Demand Futility

In *United Food & Commercial Workers Union v. Zuckerberg*,^[1] the Delaware Supreme Court restated and simplified the test for determining whether demand on the board is excused as futile. It adopted a three-part test that looks to (i) whether the director received a material personal benefit from the alleged misconduct that is the subject of the demand, (ii) whether the director faces a substantial likelihood of liability on any of the claims that would be the subject of the demand, and (iii) whether the director lacks independence from someone who received a material personal benefit from the alleged misconduct that would be, or who would face a substantial liability on any of the claims that are, the subject of the demand. If the answer to any of the questions is "yes" for at least half of the members of the board, then demand is excused as futile.

Judicial Review of Board Decisions

A recent Delaware Court of Chancery decision, *Diep v. Sather*,^[2] addressed the standard of judicial review applicable to a decision of a special litigation committee to dismiss a derivative claim. The decision confirms that the court first evaluates the independence and good faith of the committee, the reasonableness of its investigation and the bases supporting its conclusions. The court then applies its own independent business judgment to determine whether dismissal is in the best interests of the corporation, but as a practical matter the court will give deference if the committee's determination is within the range of reasonable outcomes.

Derivative v. Direct Claims

In another important decision, the Delaware Supreme Court, in *Brookfield Asset Management, Inc. v. Rosson*,^[3] overruled a decision that had been in effect for 15 years that, as an exception to the general rule, permitted a direct claim for breach of fiduciary duty against a controlling stockholder for alleged overpayment and dilution of minority stockholders' interests. The effect of this decision is to leave these claims to be pursued exclusively as derivative claims.

Key Lessons

These recent Delaware decisions rationalize and create a new framework for the rules applicable to derivative actions. On the one hand, they make those rules easier to apply. On the other, they shift the balance of authority by narrowing the ability of stockholders of Delaware corporations to bring derivative actions and give more control to boards over the decision of whether bringing the demanded action is in the corporation's best interests.

[1] 2021 WL 4344361 (Del. Sept. 23, 2021)

[2] ?2021 WL 3236322 (Del. Ch. July 30, 2021)?

[3] ?2021 WL 4260639 (Del. Sept. 20, 2021)?

RELATED INDUSTRIES + PRACTICES

- [Capital Markets](#)