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Delaware Supreme Court Adopts New Three-Part Test for Demand Futility

WRITTEN BY

J. Timothy Mast | Mary Weeks | Douglas D. Herrmann | Pamela S. Palmer

There is a new demand futility test in Delaware, adopted on September 23 by the Delaware Supreme Court in affirming dismissal of a stockholder derivative action against Facebook, Inc. (Facebook) founder, Mark Zuckerberg, and other members of Facebook's board of directors.[1] The Supreme Court established a three-pronged "universal" analysis innovated by the Court of Chancery, which blends the longstanding *Aronson*[2] and *Rales*[3] tests and eliminates the choice between them. However, the Court made clear that *Aronson*, *Rales*, and their progeny remain "good law" in applying the new test.

The new articulation treads familiar territory, assessing director disinterest, "substantial risk" of personal liability, and independence. The primary rationale for the fresh articulation is to update *Aronson* in light of developments in Delaware law, especially exculpation of director liability for breaches of care under Delaware General Corporation Law Section 102(b)(7), as well as difficulties in applying *Aronson* when boards have partially changed composition after a challenged decision. The new test strengthens the pre-suit demand requirement, powerfully reinforcing Delaware law's "cardinal precept" that "independent and disinterested directors are generally in the best position to manage a corporation's affairs, including whether the corporation should exercise its legal rights."[4]

Historically, the *Aronson* test has applied where a majority of the directors who would be considering a litigation demand were involved in the challenged, underlying decision. Demand is excused as futile if the complaint alleges particularized facts raising "a reasonable doubt" that "(1) the directors are disinterested and independent[,] [or] (2) the challenged transaction was otherwise the product of a valid exercise of business judgment."[5]

The *Rales* test has applied "in all other circumstances," including alleged failure of oversight, where no specific board action or decision is challenged.[6] 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.'"[7]

The derivative plaintiff in *Zuckerberg* challenged a board-approved reclassification of Facebook stock designed to allow Mr. Zuckerberg to fulfill a philanthropical promise to donate the vast majority of his stock to charitable causes without relinquishing voting control. The reclassification decision, approved by the stockholders, triggered class action challenges on which Facebook spent more than $21 million in defense costs before Mr. Zuckerberg asked the board to abandon the reclassification, thereby mooting the class action and resulting in a settlement of more than $68 million in fees to the plaintiffs' attorneys under the corporate benefit doctrine.[8]

Derivative plaintiff Tri-State filed a follow-on complaint on behalf of Facebook for recovery of these costs from the individual board members, alleging that any demand on the board would be futile. In granting the defendants' motion to dismiss under Court of Chancery Rule 23.1 for failing to make a pre-suit demand, the Court of Chancery opined that, although precedent "call[ed] for applying *Aronson*, … its analytical framework [was] not up to the task" given turnover on Facebook's board and the abstention of certain directors from voting on the transaction.[9]

In a trailblazing decision, the Court of Chancery applied a new three-part demand futility test, adapted from the *Aronson* and *Rales* tests. It held that Tri-State's allegations against the concededly disinterested directors who negotiated and approved the reclassification pled merely *exculpated* claims for breach of their duty of care[10] — and thus did not pose a "substantial likelihood" of personal liability. Nor did the allegations raise a "reasonable doubt" that the majority of the demand board lacked independence from Mr. Zuckerberg.[11]

In affirming dismissal, the Supreme Court established the three-part test as "the universal test for assessing whether demand should be excused as futile,"[12] obviating any need to decide whether to apply *Aronson* or *Rales*. Going forward, Delaware courts must instead consider, on a director-by-director basis, three questions:

(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 litigation demand or who would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand.[13]

"If the answer to any of the questions is 'yes' for at least half of the members of the demand board, … demand is excused as futile."[14] "This approach treat[s] '*Rales* as the general demand futility test,' while 'draw[ing] upon *Aronson*-like principles when evaluating whether particular directors face a substantial likelihood of liability as a result of having participated in the decision to approve the [challenged transaction]."[15]

The three-part test is familiar turf in Delaware.

- The first part addresses director disinterest, focusing on whether a director has a material personal interest, classically defined in the transactional context as "a personal financial benefit from the challenged transaction that is not equally shared by the stockholders."[16]
- The second part addresses the "substantial risk" of personal liability and reflects a clarification in the law as evolved since *Aronson*. Originally, *Aronson*'s own second prong looked to whether the complaint pled facts sufficient to rebut the presumption of valid business judgment — viewed at that time as giving rise to a "substantial risk" of personal liability, thereby raising doubt as to a director's ability to impartially consider a demand.[17] Post-*Aronson*, Delaware General Corporation Law Section 102(b)(7) was enacted to permit corporations to exculpate directors for gross negligence — including failure to make informed business judgments — but not for breaches of loyalty, bad faith, or improper self-dealing. Thus, Delaware courts came to the view that only facts sufficient to plead a *non-exculpated* claim for breach of fiduciary duty are sufficient to demonstrate a "substantial risk" of liability excusing demand. "The ground has … shifted, and exculpated breach of care claims [as alleged in *Zuckerberg*] no longer pose a threat that neutralizes director discretion."[18]
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> The third part addresses independence, classically defined as a fact-specific determination of whether a complaint pleads with particularity facts creating "a reasonable doubt that a director is so 'beholden' to an interested director that his or her discretion would be sterilized."[19]

Further, it does not matter whether an underlying challenged transaction would be reviewed under the deferential business judgment standard or reviewed under the entire fairness standard. What matters in assessing whether pre-suit demand is excused is solely "the ability of a corporation's board of directors to impartially consider a demand to institute litigation on behalf of the corporation, including litigation implicating the interests of a controlling stockholder."[20]

Methodically applying the three-part test, the Supreme Court determined on *de novo* review that the Tri-State complaint failed to allege a non-exculpated claim against a majority of the nine directors or to plead their lack of independence from Mr. Zuckerberg.

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[1] *United Food & Commercial Workers Union & Participating Food Ind. Emp'rs Tri-State Pension Fund v. Zuckerberg*, No. 404, 2020, __ A.3d __, 2021 WL 4344361 (Del. Sept. 23, 2021) (*Zuckerberg*).

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

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

[4] *Zuckerberg*, 2021 WL 4344361, at *14.

[5] *Id*. at *7 (citing *Aronson*, 473 A.2d at 814).

[6] *Id.* (citing *Rales*, 634 A.2d at 934).

[7] *Id.*

[8] *Id*. at *1.

[9] *Id*. at *15 (quoting *United Food & Commercial Workers Union v. Zuckerberg*, 250 A.3d 862, 890 (Del. Ch. 2020)).

[10] *Id.* at *8–12.

[11] *Id.* at *19–21.

[12] *Id*. at *16.

[13] *Id.* at *17.

[14] *Id.*

[15] *Id.* at *16.

[16] *Id*. at *13.

[17] *Id*.

[18] *Id*. at *12; *see also id*., discussing, *inter alia*, *In re Cornerstone Therapeutics, Inc. S'holder Litig.*, 115 A.3d 1173, 1175 (Del. 2015) (holding that a plaintiff "seeking only monetary damages must plead non-exculpated claims against a director who is protected by an exculpatory charter provision to survive a motion to dismiss, regardless of the underlying standard of review for the board's conduct").

[19] *Id.* at *18 (quotations omitted).

[20] *Id*. at *13 (quoting *Teamsters Union 25 Health Servs. & Ins. Plan v. Baiera*, No. CV 9503-CB, 2015 WL 4192107, at *1 (Del. Ch. July 13, 2015)).

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