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NAVIGATING DERIVATIVE LITIGATION IN DELAWARE AND PENNSYLVANIA: A COMPARATIVE ANALYSIS

Delaware and Pennsylvania take different approaches to derivative litigation. While both states require stockholders to make a demand upon the corporation, Delaware allows demand to be excused if the stockholder can show that a majority of the board is incapable of making an impartial decision regarding the litigation. In contrast, Pennsylvania does not recognize the concept of demand futility and provides that a corporation can establish a Special Litigation Committee to determine whether pursuing litigation is in the best interests of the corporation. Understanding these differences is essential for effectively navigating derivative litigation in these jurisdictions.

By Jay A. Dubow, Katie Rose Hancin, and Dominique Hazel-Criss *

DERIVATIVE LITIGATION IN DELAWARE

Under Delaware law, a derivative action is defined as “an action on behalf of an entity to enforce a claim that the entity could assert.”¹ Deemed a “cardinal precept of Delaware law,” directors, as opposed to shareholders, are given the responsibility of managing the business and affairs of the corporation.² Given this board-centric model, Delaware places a demand requirement on stockholders seeking to act as a corporation for litigation purposes.³ A demand requirement “(1) ensures that a stockholder exhausts his intracorporate remedies,

(2) provides a safeguard against strike suits, and (3) assures that the stockholder affords the corporation the opportunity to address an alleged wrong without litigation and to control any litigation which does occur.”⁴

DEMAND FOR DELAWARE CORPORATIONS

To pursue a derivative action in Delaware, a plaintiff must first establish standing. This requires the plaintiff to have been a stockholder at the time of the alleged misconduct and to continue to hold the shares

¹ Del. Ch. Ct. R. 23.1(f)(1).

² *In re Fox Corp. Deriv. Litig.*, No. 2023-0418, 2024 WL 5233229, at *7 (Del. Ch. Dec. 27, 2024).

³ *Crispo v. Musk*, 304 A.3d 567, 576 (Del. Ch. 2023).

⁴ *United Food & Com. Workers Union & Participating Food Indus. Emps. Tri-State Pension Fund v. Zuckerberg*, 262 A.3d 1034, 1047 (Del. 2021) (cleaned up).

* JAY A. DUBOW is a partner, KATIE ROSE HANCIN is an associate, and DOMINIQUE HAZEL-CRISS is a summer associate at Troutman Pepper Locke, LLP’s Philadelphia office. Jay focuses his practice on complex business litigation, specifically on defending against shareholder derivative and securities class action litigation. Katie is a member of the business litigation practice. Their e-mail addresses are jay.dubow@troutman.com and katie.hancin@troutman.com.

throughout the litigation.⁵ Once standing is established, the stockholder may proceed with the derivative action if (1) they have first demanded that the directors pursue the corporate claim and the directors wrongfully refused to do so or (2) such demand is excused because the directors are deemed incapable of making an impartial decision regarding pursuit of the litigation.⁶

There are no “magic words” or “all-inclusive legal formula[s]” to determine whether a pre-suit stockholder communication is a demand.⁷ Generally, a communication will be considered a demand if it provides “(1) the identity of the alleged wrongdoers, (2) the wrongdoing they allegedly perpetrated and the resultant injury to the corporation, and (3) the legal action the shareholder wants the board to take on the corporation’s behalf.”⁸ The three-part demand test calls for a holistic analysis of the nature of the communication and considers “whether the communication substantively places a board on notice of the claim to be pursued.”⁹

Under Delaware Court of Chancery Rule 23.1, in contrast to Delaware’s permissive “notice” pleading standard, a derivative plaintiff must plead with particularity that the demand was either wrongfully refused or futile.¹⁰ A stockholder can only argue the demand was wrongfully refused *or* futile — not both.¹¹ If a board does not act independently in responding to the demand, such as by succumbing to an extraneous influence or financial interest in the action, this lack of

independence can support a showing of wrongfulness of a refusal.¹² Once a board receives a demand, it can establish a “demand review committee to conduct a review of the demand proportional to the nature and strength of the claims and decide if it is in the best interests of the corporation to pursue the claims.”¹³

WRONGFUL REFUSAL FOR DELAWARE CORPORATIONS

If the board rejects a litigation demand, the demand is afforded the protections of the business judgment rule, which presumes directors acted in good faith and on an informed basis.¹⁴ The only issues left to examine are whether the board acted in good faith and the reasonableness of its investigation after the demand refusal.¹⁵ To establish bad faith, plaintiffs must plead “particularized allegations that a director’s decision was so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any other ground.”¹⁶ The directors must have either acted with “an intent to harm or a knowing indifference to the harm caused.”¹⁷ Where the reasonableness of an investigation is questioned, a gross negligence inquiry is implicated to ask whether the board properly informed itself of material information available prior to refusal.¹⁸ Gross negligence is defined as “conduct that constitutes reckless indifference or actions that are without the bounds of reason.”¹⁹

⁵ *In re Smiledirectclub, Inc. Derivative Litigation*, No. 2019-0940, 2021 WL 2182827, at *7 (Del. Ch. May 28, 2021).

⁶ *Id.*

⁷ *Solak v. Welch*, No. 2018-0810, 2019 WL 5588877, at *4 (Del. Ch. Oct. 30, 2019).

⁸ *Id.* (quoting *Yaw v. Talley*, No. 12882, 1994 WL 89019, at *7 (Del. Ch. Mar. 2, 1994)).

⁹ *Raj & Sonal Abhyanker Fam. Tr. V. Blake*, No. 2020-0521, 2021 WL 2477025, at *6 (Del. Ch. June 17, 2021).

¹⁰ Del. Ch. Ct. R. 23.1.

¹¹ *Diep v. Trimaran Pollo Partners*, 280 A.3d 133, 150 (Del. 2022).

¹² *Grimes v. Donald*, 673 A.2d 1207, 1219 (Del. 1996) (“A board or a committee of the board may appear to be independent, but may not always act independently.”).

¹³ *Diep*, 280 A.3d at 150.

¹⁴ *In re Kraft Heinz Demand Refused Deriv. S’holder Litig.*, No. 2022-0398, 2024 WL 3493957, at *5 (Del. Ch. July 19, 2024).

¹⁵ *Spiegel v. Buntrock*, 571 A.2d 767, 777 (Del. 1990).

¹⁶ *Kraft Heinz*, 2024 WL 3493957, at *8 (internal quotation omitted).

¹⁷ *Id.*

¹⁸ *Id.* at *18.

¹⁹ *Id.*

The board has wide discretion when responding to a demand, as there is *no prescribed procedure* it must follow.²⁰ For example, the choice of documents to review or people to interview may reasonably vary, so potential leads may not be pursued in an investigation.²¹ Refusing legitimate litigation demands due to excessive costs or detriments to the long-term strategic interests of the corporation is also within the board's bounds of business judgment.²² Therefore, to rebut a board's decision to reject a demand, a plaintiff must "create a reasonable doubt as to the Board's compliance with its fiduciary duty of care," not prove that the Special Demand Review Committee was wrong.²³

In re Kraft Heinz Demand Refused Derivative Shareholder Litigation illustrates this rule.²⁴ In this case, shareholders demanded an investigation into insider trading and after the board's Working Group conducted a two-year investigation, it recommended against litigation. The shareholders sued, claiming that the Working Group was conflicted, did not adequately investigate, and reached unsupported conclusions. The court rejected these arguments for four reasons. First, the demand conceded the board's lack of conflicts, and, in any event, the board was not required to cede full control to an independent committee. Second, interested directors are not inherently prohibited from serving on review committees, and plaintiffs failed to show an impactful conflict. Third, additional potential investigatory avenues did not support a finding that the Working Group's extensive investigation was conducted in bad faith. Fourth, the Working Group's conclusions are entitled to business judgment deference, even though plaintiffs disagree with them.

DEMAND FUTILITY FOR DELAWARE CORPORATIONS

In Delaware, a lawsuit may be brought without first bringing a demand if the demand would be futile. The demand-futility analysis assesses "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."²⁵ Delaware Court of Chancery Rule 23.1 imposes a *stringent pleading requirement* to determine a stockholder's standing to sue at the outset of a case.²⁶ The Delaware Supreme Court "has repeatedly admonished plaintiffs to use the 'tools at hand' and to request company books and records under [DGCL] Section 220 to attempt to substantiate their allegations before filing derivative complaints."²⁷

The Zuckerberg Futility Test evaluates demand futility by asking 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 related to the litigation demand, and (3) whether the director lacks independence from someone who received a material personal benefit from the alleged misconduct or who would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand.²⁸ If any of these questions are answered affirmatively for *at least half* of the demand board, which is the board in place at the time the complaint was filed, then the demand will be excused as futile.²⁹

A director's independence must be measured by whether their "decision is based on the corporate merits of the subject before the board, rather than extraneous considerations or influences."³⁰ The question then becomes "whether applying a subjective standard, [the director's ties to an interested person] were *material* in the sense that the alleged ties could have affected the impartiality of the individual director."³¹ Subject to the materiality requirement, particularly close familial, business, and even social relationships can all affect a director's independence.³² The analysis is holistic and

²⁰ *Id.* at *12.

²¹ *Mount Moriah Cemetery v. Moritz*, No. 11431, 1991 WL 50149, at *4 (Del. Ch. Apr. 4, 1991).

²² *Kraft Heinz*, 2024 WL 3493957, at *16.

²³ *Zucker v. Hassell*, No. 11625, 2016 WL 7011351, at *9 (Del. Ch. Nov. 30, 2016) (emphasis added).

²⁴ *Kraft Heinz*, 2024 WL 3493957, at *10.

²⁵ *United Food & Com. Workers Union & Participating Food Indus. Emps. Tri-State Pension Fund v. Zuckerberg*, 262 A.3d 1034, 1059 (Del. 2021).

²⁶ *Lebanon Cnty. Emps.' Ret. Fund v. Collis*, 311 A.3d 773, 796 (Del. 2023).

²⁷ *Cal. State Teachers' Ret. Sys. v. Alvarez*, 179 A.3d 824, 839 (Del. 2018).

²⁸ *Zuckerberg*, 262 A.3d at 1059.

²⁹ *Id.*

³⁰ *Id.* at 1060.

³¹ *Id.* at 1061.

³² *In re Fox Corp. Deriv. Litig.*, No. 2023-0418, 2024 WL 5233229, at *14, *15-16, *18-19 (Del. Ch. Dec. 27, 2024).

context-driven, accounting for the full array of human motivations, not just financial ones.³³

In re Fox Corporation Derivative Litigation involved stockholder plaintiffs who alleged that Fox’s board harmed Fox by causing it to sustain defamation liability.³⁴ The stockholders sued without making a demand, claiming at least four of Fox’s eight directors could not impartially consider a demand. The court agreed, citing Rupert Murdoch’s potential liability due to his management role, Lachlan Murdoch’s lack of independence as Rupert’s son, Chase Carey’s indebtedness to Rupert, and Jacques Nasser’s close ties to Rupert, all of which the court stated raised doubts about their impartiality.

DERIVATIVE LITIGATION IN PENNSYLVANIA

Like Delaware, Pennsylvania allows plaintiffs to “maintain a derivative action to enforce a right of a business corporation.”³⁵ To initiate a derivative action in Pennsylvania, a plaintiff must first establish standing. This requirement, akin to Delaware’s, requires a plaintiff to have been a shareholder or to have held a beneficial interest at the time of the conduct at issue and continue to hold the shares until the judgment.³⁶ Despite these similarities, Pennsylvania’s derivative litigation procedure has procedural differences that give Pennsylvania corporations more flexibility in handling these actions.

DEMAND AND DEMAND EXCUSED FOR PENNSYLVANIA CORPORATIONS

Before proceeding with a derivative action, a plaintiff must first make a demand on the corporation or board of directors, providing an opportunity to investigate and remedy the alleged wrongdoing. The demand must state with reasonable specificity the essential facts relied upon to support each of the claims.³⁷ If the corporation fails to bring an action within a reasonable time, or if a Special Litigation Committee determines that the action should continue, the plaintiff may maintain the action.³⁸

Although Pennsylvania’s derivative litigation statute provides that a plaintiff may maintain a derivative action

if demand is excused, Pennsylvania does not recognize the concept of demand excuse. Even if a plaintiff demonstrates that “immediate and irreparable harm” to the corporation would result from making the demand, they must still make a demand promptly upon the commencement of the action.³⁹ This is unlike in Delaware, where a plaintiff who makes a showing of demand futility will be excused from making the demand.

SPECIAL LITIGATION COMMITTEE’S RESPONSE TO A DEMAND TO A PENNSYLVANIA CORPORATION

A unique feature of Pennsylvania’s derivative litigation process is the involvement of a Special Litigation Committee, which investigates the claims and determines whether pursuing litigation is in the corporation’s best interests. The Committee must be comprised of two or more individuals who (1) are not interested in the claims asserted in the demand, (2) are capable of objective judgment, and (3) may, but need not be, shareholders or directors.⁴⁰ The Committee must notify the shareholder who made the demand, or the plaintiff if a complaint was filed, of the Committee’s members once they have been appointed.⁴¹

Process is key with regard to the Committee’s formation and investigation. The Committee needs to conduct a thorough investigation, usually involving interviews with board members and other employees to assess the validity of the allegations. The primary objective of the investigation is to gather information to guide the Committee’s determination on whether the corporation should proceed with litigation. If a complaint was filed, the court may stay discovery for the time reasonably necessary for the Committee to complete its investigation.⁴² It is recommended that the Committee have independent counsel for the investigation to ensure compliance with laws and regulations, as well as to bolster the credibility of its findings.

Following its investigation, the Committee will draft a statement of determination as to whether litigation is in the corporation’s best interests, accompanied by a detailed report supporting its findings. The Committee’s recommendations to the board can vary based on whether a derivative action has already been initiated. If

³³ *Id.* at *17.

³⁴ *Id.* at *4.

³⁵ 15 Pa. C.S.A. § 1781(a).

³⁶ 15 Pa. C.S.A. § 1782(a).

³⁷ 15 Pa. C.S.A. § 1781(c).

³⁸ 15 Pa. C.S.A. § 1781(a).

³⁹ 15 Pa. C.S.A. § 1781(b)(1).

⁴⁰ 15 Pa. C.S.A. § 1783(c).

⁴¹ 15 Pa. C.S.A. § 1783(a).

⁴² 15 Pa. C.S.A. § 1783(b)(1).

a derivative action was already commenced, the Committee may recommend to the board that (1) the action continue, (2) some or all of the claims be settled on terms recommended by the Committee, or (3) the action be dismissed.⁴³ Conversely, if a derivative action was not already commenced, the Committee may recommend that (1) an action not be brought by the corporation, but the corporation not object to an action being brought by the party who made the demand, (2) an action be brought by the corporation, (3) claims in the demand be settled on terms determined by the committee, or (4) an action not be brought.⁴⁴ Only where a derivative action was or will be commenced must the Committee file its statement of determination and report with the court.

A plaintiff who disagrees with the Committee's findings and recommendation may challenge them, but such challenges are limited to procedure, not substance. Courts generally defer to the Committee's judgment, provided its members acted objectively, independently, in good faith, and with reasonable care.

The landmark case of *Cuker v. Mikalauskas* established the standard for defending a Special Litigation Committee's findings.⁴⁵ Decisions regarding litigation by or on behalf of a corporation fall within the scope of the business judgment rule, which insulates officers and directors from judicial intervention so long as they made decisions within the scope of their authority, with reasonable diligence, and in good faith. In making this determination, courts consider factors such as whether the committee was disinterested, assisted by counsel, prepared a written report, was independent, conducted an adequate investigation, and acted in good faith. If these criteria are satisfied, the business judgment rule applies, and the court will dismiss the action.

Lemenstrel v. Warden provides an illustration of this rule.⁴⁶ In this case, the Committee determined that a derivative action would not be in the best interests of the

corporation. The plaintiff challenged this finding, arguing that the Committee did not act independently or in good faith. The Committee's members, who were directors and members of the corporation's compensation committee, were named as defendants in the derivative lawsuit. However, its members were not involved in the actions alleged in the demand letter. The Committee conducted an extensive investigation, engaging highly competent outside counsel who reviewed thousands of documents and interviewed multiple witnesses to determine the validity of the allegations. Consequently, the court determined that the Committee was properly formed, independent, adequately informed, conducted an adequate investigation, properly utilized outside counsel, acted in good faith, and produced an extensive report. It deferred to the Committee's findings under the business judgment rule and dismissed the action. This case underscores the importance of procedural rigor and independence in the functioning of Special Litigation Committees.

KEY CONSIDERATIONS FOR NAVIGATING DERIVATIVE ACTIONS IN DELAWARE AND PENNSYLVANIA

Overall, the landscape of derivative litigation in Delaware and Pennsylvania reflects each state's unique approach to corporate governance. A key aspect of Delaware's approach is the concept of demand excused, which allows shareholders to bypass the demand requirement if they can demonstrate that the board is incapable of making an impartial decision regarding the litigation. Pennsylvania's approach differs, particularly in its handling of demand excuses and the role of Special Litigation Committees. The absence of demand futility in Pennsylvania underscores the state's distinct procedural nuances, requiring plaintiffs to navigate a different legal framework. For legal practitioners and corporate stakeholders, understanding these differences is crucial for effectively navigating derivative litigation. ■

⁴³ 15 Pa. C.S.A. § 1783(e).

⁴⁴ *Id.*

⁴⁵ *Cuker v. Mikalauskas*, 547 Pa. 600 (1997).

⁴⁶ *Lemenstrel v. Warden*, 964 A.2d 902 (Pa. 2008). *See also Braun on Behalf of USA Technologies, Inc. v. Herbert*, 180 A.3d 482 (Pa. 2018) (upholding the Committee's determination where the plaintiffs failed to allege with any particularity that the members' service on the board prevented them from being disinterested).