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DIRECTORS' AND OFFICERS' LIABILITY
DEMAND FUTILITY IN DERIVATIVE ACTIONS

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Whether a corporation should assert a claim is a business decision ordinarily committed to the business judgment of the board. To preserve this prerogative, the law in Delaware and elsewhere requires that a shareholder who wishes to pursue the extraordinary remedy of bringing a derivative suit to assert a right belonging to the corporation must first make a demand on the directors to assert the right, or establish why demand is excused. In three recent Delaware Court of Chancery decisions addressing motions to dismiss derivative complaints for failure to make a pre-suit demand, Vice Chancellor John W. Noble addressed several important features of Delaware law regarding demand futility. The decisions provide a good survey of what may and may not provide a basis to challenge director disinterest and independence.

The Demand Requirement

The demand requirement compels dismissal of any derivative complaint that does not allege with particularity the efforts taken by the plaintiff to demand action by the board or, alternatively, particularized facts explaining that a demand was not made because it would have been futile. Recognizing that the decision to initiate litigation is a business decision, the demand requirement seeks to "affor[d] the directors an opportunity to exercise their reasonable business judgment and 'waive a legal right vested in the corporation in the belief that its best interests will be promoted by not insisting on such right.'"[i]

The futility exception to the demand requirement establishes limited circumstances in which a shareholder is permitted to circumvent the board's authority to manage corporate affairs and commence litigation on behalf of the corporation without making a pre-suit demand on the board. To properly allege futility in a paradigmatic derivative action challenging a transaction about which the board made a conscious decision either to act or to refrain from acting, the shareholder must satisfy the *Aronson* test and allege facts creating a reasonable doubt either that: (1) the directors are disinterested and independent or (2) the challenged transaction otherwise was the product of a valid exercise of business judgment.[ii] These inquiries are disjunctive; demand is excused if either standard is met.

Delaware courts apply a different standard to determine whether demand would have been futile in cases where the board to which demand would be made has made no conscious decision that is challenged in the derivative litigation. As the Delaware Supreme Court

observed in *Rales v. Blasband*,[iii] "[t]his situation would arise in three principal scenarios: (1) where a business decision was made by the board of a company, but a majority of the directors making the decision have been replaced; (2) where the subject of the derivative suit is not a business decision of the board; and (3) where . . . the decision being challenged was made by the board of a different corporation." In these limited circumstances, the absence of board action makes it impossible to apply the *Aronson* test to determine "whether the directors have acted in conformity with the business judgment rule in approving the challenged transaction."[iv] Consequently, the court must determine whether the particularized allegations of the derivative "complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand."

Recent Decisions

In *In re National Auto Credit, Inc. Shareholders Litig.*[v], Vice Chancellor Noble denied a motion to dismiss a derivative complaint for failure to make a pre-suit demand under *Aronson* in a decision that explored when separate transactions may be considered together for purposes of determining demand futility. Plaintiffs sought to allege derivative breach of fiduciary duty and waste claims against the directors of NAC regarding three resolutions approved at the same board meeting. The resolutions (i) approved an employment agreement and compensation package for the CEO; (ii) authorized the acquisition of ZoomLot, a "dot-com" company, in a transaction plaintiffs alleged transferred 26.7% of NAC's common stock to the seller who was aligned with the CEO; and (iii) awarding compensation to the directors for past services in addition to increasing their directors' fees.

Plaintiffs alleged that the three resolutions were an integrated package designed to consolidate the CEO's control of NAC while enriching the defendant directors. Consequently, they argued that pre-suit demand was excused as futile "because the challenged transactions are each a *quid pro quo* for the others and the [Defendant Directors] are personally interested in the challenged transactions collectively."[vi] The establishment of demand futility turned on whether the complaint raised an inference of interrelation among the transactions, because considered separately a majority of directors did not have a material personal financial interest in each resolution.

The court ruled that "[i]n deciding whether to consider a sequence of transactions separately or collectively, the Court reviews the circumstances surrounding the challenged transactions, as alleged by the particularized facts of the complaint, to decide whether it can be reasonably inferred that those transactions constituted a single, self-interested scheme."[vii] The court concluded that the complaint created the reasonable inference by particularized allegations that the resolutions were adopted within minutes of each other and immediately followed NAC's repurchase of a significant block of NAC stock, combined with a standstill agreement preventing the selling stockholder from making further stock purchases.

With this contextual perspective, the court concluded that the complaint created a reasonable inference that the defendant directors voted on the CEO's employment agreement and the ZoomLot acquisition knowing there was a "causal link to their remuneration" in the form of the resolution approving increases in their compensation.[viii] The court acknowledged the general rule that receipt of directors' fees does not create a disqualifying interest, but stated that fees materially exceeding customary and usual director compensation may compromise directors' ability to disinterestedly consider a demand to bring suit. The court excused plaintiffs' failure to make ordinarily required allegations about the materiality of the increased compensation to each director based on his or her financial circumstances. Where the compensation constituted "massive increases" over existing compensation, the court reasoned it could be inferred "that such amounts are material." Accordingly, the court concluded that the particularized allegations of the complaint created a reasonable doubt as to the disinterestedness of a majority of the board concerning the three resolutions.

In *California Pub. Empl. Ret. Sys. v. Coulter,*[ix] plaintiff made no pre-suit demand before alleging multiple derivative claims against certain current and former directors and officers of Lone Star Steakhouse & Saloon. The derivative claims challenged (i) numerous repricings of options owned by company employees and outside directors; (ii) the company's acquisition of an entity wholly owned by the current CEO and company founder; and (iii) change of control agreements with key executives which, if triggered, would have obligated the company to pay an amount equal to one-eighth of the company's market capitalization.

Recognizing that the disinterest and independence of a majority of the board must be evaluated director-by-director, the court reviewed the complaint's allegations of various directors' interest in the challenged transactions and the directors' ability to act independently of an allegedly controlling CEO.

As to the option repricings, the court noted the general rule that mere approval of, or acquiescence in, a challenged decision, by itself, does not create reason to doubt a director's disinterest or independence. The court rejected plaintiff's argument that the repricing of certain outside directors' options approved by inside directors raised an inference that the outside directors' approval of other challenged transactions was based on factors extraneous to the merits of the transactions.

The court concluded, however, that the complaint raised a reasonable doubt that a majority of the directors could disinterestedly consider a shareholder demand on an entrenchment claim. Holding that "[d]irectors are presumptively 'interested' in . . . actions taken for entrenchment purposes," the court ruled that a majority of the board could not disinterestedly consider a claim based on allegations that generous golden parachute agreements for certain directors triggered by a change of control were instituted for entrenchment purposes, at least when the board had recently received serious shareholder criticism.[x]

The court also had occasion to address under what circumstances allegations of personal friendship and outside business relationships may compromise a directors' independence to consider a demand. The court observed that generally such considerations, without more, fail to create reasonable doubt. Two directors, however, had multiple and significant personal and business connections to the CEO that led the court to conclude they were not able to independently consider a demand to challenge transactions favored by the CEO. For one director, doubt was raised by the cumulative impact of a lifelong friendship with the CEO, the director's son's employment by the CEO and various business and financial ties to the CEO. For an inside director, the court accepted that reasonable doubt as to independence was raised by the fact that the CEO "ha[d] been the [director's] superior with regard to [the director's] primary employment through [his] last three positions and two employees." The court also relied on particularized allegations that this director had orchestrated the company's purchase of an entity controlled by the CEO for more than fair value.

The court then analyzed the challenged transactions under the second *Aronson* inquiry – "whether the challenged decision[s were] the product of the valid exercise of business judgment."[xi] The court separately considered various repricings of employee and outside director options, and reached different conclusions. As to an employee option repricing for which the complaint alleged "the only document in Lone Star's corporate records" was "the signed resolution of the Stock Option Committee implementing the repricing," the court held that question had been raised about the exercise of valid business judgment. Demand was not excused, however, for employee option repricing claims lacking this allegation.

The court also concluded that demand was excused as to claims challenging the acquisition of an entity owned by the CEO, because the complaint raised reasonable doubt as to whether the acquisition was the product of the board's exercise of valid business judgment. The analysis centered on the board's purported reliance on an investment bank's valuation report. Although directors ordinarily are entitled to rely on expert advice in their decision-making, the court declined to accept the board's reliance on the investment bank valuation. The court held that particularized allegations that "some of the bases of the . . . valuation opinion were fabricated and unfounded" established doubt as to the board's ability to rely in good faith on the valuation. The court bolstered its business judgment conclusion by reference to allegations that the CEO commandeered the board's consideration of the acquisition. The court acknowledged that "a special committee was formed to evaluate and approve the transaction," but "the . . . complaint allege[d] particularized facts that the special committee abdicated its role to [the CEO] and those controlled by him."[xii]

In *Zimmerman v. Braddock,*[xiii] plaintiff commenced a derivative action on behalf of priceline.com against most of the company's board without first making a demand upon the board. The complaint alleged that for eighteen months the defendants made materially false and misleading statements concerning the company's financial condition and future prospects that afforded three directors the opportunity collectively to sell more than ten million shares of

company stock at artificially inflated prices. The company's stock declined precipitously shortly after the directors' stock sales. Contending that the stock sales were based on confidential, inside information, plaintiff alleged that the defendant directors breached their fiduciary duties and committed acts of waste by failing to prevent the alleged insider trading.

Defendants moved to dismiss on the ground that the complaint failed to set forth particularized facts demonstrating that demand would have been futile. The court began by noting that the complaint's allegations of breach of fiduciary duty based on the board's failure to act, "as opposed to a conscious decision to act or abstain from acting," called for the *Rales* test and not the *Aronson* test for determining demand futility. Accordingly, demand would not be excused unless the complaint demonstrated a reason to doubt "that, as of the time the complaint [was] filed, the board . . . could have properly exercised its independent and disinterested business judgment in responding to a demand." In *Zimmerman*, this required plaintiff to raise doubt concerning the independence or disinterestedness of at least six of priceline's eleven directors. Because it was undisputed that only three directors had directorial interest – material personal financial benefit from the challenged transaction – the court concluded that demand futility would hinge on whether the complaint reasonable doubt as to the independence of at least six directors from the stock selling directors.

Holding that "a director's independence may be called into question when the allegedly controlling director has the power . . . solely . . . or in conjunction with others who share his purpose, to exert pressure on the challenged director's ability to consider the merits of a demand for suit objectively," the court held that plaintiff failed to meet this burden as to any director.[xiv] The court rejected plaintiff's argument that the stock sellers exerted control through various entities allegedly controlled by the stock sellers.

Plaintiff also alleged that multiple priceline directors had significant equity stakes in or business dealings with entities that the stock sellers purportedly controlled. The common flaw in these allegations, however, was the failure to allege the specific equity interest that the selling defendants had in these related entities, or the equity interest such entities had in priceline. The court concluded that without specific allegations showing that the stock sellers' equity interests directly or indirectly controlled priceline, the complaint failed to raise a reasonable doubt as to the non-stock seller directors' ability to act independently in considering a demand. Accordingly, the court dismissed the complaint for failure to make pre-suit demand.

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i *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 533 (1984) (quoting *Corbus v. Alaska Treadwell Gold Mining Co.*, 187 U.S. 455, 463 (1903)).

ii *See Brehm v. Eisner*, 746 A.2d 244, 256 (Del. 2000) (en banc); *Aronson v. Lewis*, 473 A.2d 805, 813-14 (Del. 1984).

iii 634 A.2d 927, 934 (Del. 1993).

[iv] *Id*. at 933.

[v] 2003 WL 139768 (Del. Ch. Jan. 10, 2003).

[vi] *Id*. at *7.

[vii] *Id*. at *9.

[viii] *Id*. at *11.

[ix] 2002 WL 31888343 (Del. Ch. Dec. 18, 2002).

[x] *Id*. at *8.

[xi] *Id*. at *10.

[xii] *Id*. at *13.

[xiii] 2002 WL 31926608 (Del. Ch. Dec. 20, 2002).

[xiv] *Id*. at *8.