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Delaware Derivative Litigation Moves Forward Two Steps

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The Delaware Supreme Court recently issued two rulings that meaningfully change the landscape of shareholder derivative litigation. One of them explicitly overturned fifteen years of precedent on whether certain stockholder claims are direct or derivative. The second created a new test for demand futility in derivative cases.

A stockholder derivative action is a particular kind of lawsuit. In a normal case, a plaintiff sues a defendant for harm that the defendant caused to the plaintiff. Some stockholder cases, such as cases for certain types of securities fraud or breach of fiduciary duty, are like this; they are known as *direct* claims. There, a stockholder plaintiff might claim, for example, that it was defrauded into making an investment under false pretenses and thereafter lost money. *Derivative* cases, on the other hand, proceed under a different theory. In a derivative case, a stockholder plaintiff complains that a company's board failed to discharge its duties to the company and thereby caused the company harm. The stockholder, in that case, brings a lawsuit *on the company's behalf* against its board of directors and seeks recovery for the benefit of the company. The unique nature of derivative claims creates additional procedural requirements that most plaintiffs would prefer to avoid. Therefore, the question of whether certain types of claims are more properly classified as direct or derivative is hotly contested.

In *Brookfield Asset Management v. Rosson*, the Delaware Supreme Court overturned existing case law that delineated which claims are direct and which claims are derivative in certain circumstances. In *Brookfield*, Brookfield Asset Management acquired \$650 million in shares of TerraForm Power and increased its interest in TerraForm from 51% to 65%. Minority stockholders brought suit alleging that Brookfield underpaid and that the company therefore diluted their, the minority stockholders', interests. The Delaware Chancery Court had held that, under the Delaware Supreme Court's 2006 decision in *Gentile v. Rosette*, a stockholder who allegedly suffered dilution as the result of a controlling shareholder's actions was entitled to pursue a direct claim. On appeal, the Supreme Court acknowledged that the Chancery Court had correctly applied *Gentile* to the facts at hand, but then explicitly overruled *Gentile*. Citing tension between *Gentile* and other Delaware decisions that articulate the difference between direct claims and derivative ones, the court "re-establish[ed] a consistent rule that equity overpayment/dilution claims, absent more, are exclusively derivative."

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Brookfield Asset Mgt. et al. v. Rosson et al., No. 406, 2020 (Del. Sept. 20, 2021), *overruling Gentile v. Rosette*, 906 A.2d 91 (Del. 2006).

A few days after *Brookfield*, the Delaware Supreme Court issued another major decision in a derivative case involving Facebook. In *United Food and Commercial Workers v. Zuckerberg*, the Court reexamined a second facet of derivative litigation: the standard for “demand futility.” In derivative litigation, before a stockholder plaintiff commences suit, the plaintiff must first make a *demand* on the company’s board of directors to take action—to remedy whatever issues the stockholder complains of. If the stockholder skips this step, then the stockholder must demonstrate that demand was *futile*.

Demand futility was the precise thing at issue in *United Food*. The case concerned Mark Zuckerberg’s attempt to engage in a share reclassification such that he could reduce his ownership stake in Facebook while retaining voting control. That attempted reclassification, later abandoned, resulted in litigation generating legal fees and settlement expense for the company. Following that litigation and associated expense, a Facebook stockholder brought a derivative claim alleging that Facebook’s board breached its fiduciary duties to the company in permitting Zuckerberg’s plan in the first place. The stockholder sued, on behalf of the company, to recoup from the directors money that the company spent defending the prior litigation and settling that case. Before filing suit, however, the stockholder did not make a demand on the board to take action. Instead, the stockholder alleged that demand would have been futile because the board’s decision to approve reclassification was not fully informed and because the board lacked independence from Zuckerberg. On the particular facts of the case, the Chancery Court articulated a new, three-part test for assessing whether directors are independent for the purposes of determining whether demand is futile:

- (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.

Applying this test, the Chancery Court, which had suggested that this test be adopted going forward, found that demand would *not* have been futile and was not excused. A majority of the directors did not have a personal interest in the reclassification. A majority of the directors did not face any substantial likelihood of liability, as Facebook’s governing documents have a provision exculpating directors from this type of claim. And finally, the plaintiff did not plead sufficient facts to show that the board lacked independence from Zuckerberg. On appeal, the Delaware Supreme Court adopted the three-part test used by the Delaware Chancery Court and affirmed the Chancery Court’s judgment. The new test is important, because it clarifies aging precedent that did not account for more recent developments in Delaware law. *United Food & Commercial*

Workers Union v. Mark Zuckerberg, et al. and Facebook, Inc., No. 404, 2020 (Del. Sept. 23, 2021), affirming 250 A.3d 862 (Del. Ch. 2020).

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While the long-term effect of these decisions on the derivative litigation landscape remains to be seen, the recent decisions appear to have been a significant step forward in the evolution of Delaware corporate law.