Delaware Supreme Court Issues Two Opinions Simplifying Delaware Law on Derivative Claims

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In one week, the Delaware Supreme Court handed down two important opinions simplifying Delaware law on derivative claims.

On September 23, 2021, in *United Food and Commercial Workers Union and Participating Food Industry Employers Tri-State Pension Fund v. Zuckerberg*, No. 404, 2020 (Del. 2021), the Delaware Supreme Court adopted a new three-part test for evaluating demand futility, "blending" and replacing the tests formerly set out in the seminal cases *Aronson v. Lewis* and *Rales v. Blasband*. Going forward, this will be the "universal test for assessing whether demand should be excused."

Three days prior, in *Brookfield Asset Management, Inc. v. Rosson*, No. 406, 2020 (Del. 2021), the Delaware Supreme Court reexamined principles of direct and derivative standing, overruling its 15-year-old decision, *Gentile v. Rossette*, 906 A.2d 91 (Del. 2006), and holding that corporation overpayment/dilution claims — including those resulting from a transaction that transfers economic value and voting power from minority stockholders to a controlling stockholder — are "exclusively derivative."

These two decisions offer critical insights into how Delaware courts will evaluate derivative claims going forward.

United Food and Commercial Workers Union and Participating Food Industry Employers Tri-State Pension Fund v. Zuckerberg

In *Tri-State*, plaintiff stockholders filed a derivative action seeking to recover nearly $90 million that Facebook had spent defending and settling an earlier consolidated class action challenging a reclassification that was ultimately abandoned. The Court of Chancery noted that under the facts of the case, which included board turnover and certain board member recusals, it was unclear whether the test articulated in *Aronson* or *Rales* applied for purposes of assessing demand futility. The court instead applied a three-pronged standard derived from both *Aronson* and *Rales* and dismissed the complaint for failure to plead that demand was futile.

The Delaware Supreme Court adopted the Court of Chancery's new three-part test for demand futility, explaining that although *Aronson* "made sense" at the time it was decided, "[s]ubsequent changes in the law have eroded the ground upon which that framework rested. Those changes cannot be ignored, and it is both appropriate and necessary that the common law evolve in an orderly fashion to incorporate those developments."

Going forward, in determining whether demand is futile, the court will consider:

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 faces 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.

If the answer to these questions is "yes" for at least half of the members of the demand board, then demand is excused as futile. In adopting this new test, the Delaware Supreme Court emphasized that while the former tests proved difficult to apply in many contexts,

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cases properly applying *Aronson* and *Rales* remain good law. Parties, however, will no longer need to wrestle with the question of which test to use.

Among other interesting aspects of its ruling, the Delaware Supreme Court rejected Tri-State's argument that demand was "automatically excused under *Aronson*'s second prong" because Mark Zuckerberg, Facebook's controlling stockholder, stood on both sides of the challenged transaction, implicating the entire fairness standard of review. The Delaware Supreme Court further explained, after thoroughly reviewing *Aronson* and its progeny — as well as the adoption and application of Section 102(b)(7) after the *Aronson* decision — that exculpated care claims do not expose directors to a substantial likelihood of liability and cannot satisfy this standard.

Brookfield Asset Management, Inc. v. Rosson

In 2004, the Delaware Supreme Court issued its decision in *Tooley v. Donaldson, Lufkin & Jennette, Inc.*, in which it "undertook to create a simple test of straightforward application to distinguish direct claims from derivative claims" by asking: "(1) who suffered the alleged harm (the corporation or the stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?" Two years later, in 2006, the Delaware Supreme Court decided *Gentile*, holding that although claims for overpayment are typically derivative, claims involving "a controlling stockholder and transactions that resulted in an improper transfer of both economic value and voting power from the minority stockholders to the controlling stockholder" present an exception to the *Tooley* test and are "dual-natured," *i.e.*, both derivative and direct.

In *Brookfield*, plaintiff stockholders challenged TerraForm Power, Inc.'s private placement of stock to its controlling stockholder. Plaintiffs alleged that TerraForm undervalued the stock and that the transaction diluted both the financial and voting interests of the minority stockholders. After the plaintiffs filed their complaint, the controlling stockholder acquired TerraForm's remaining shares in a merger. The defendants moved to dismiss the complaint for lack of standing, arguing that dilution claims are "quintessential derivative claims" under the *Tooley* test, and that the derivative claims had been extinguished by the merger.

The Court of Chancery agreed that the plaintiffs failed to state direct claims under *Tooley*, but nevertheless denied the motion to dismiss because the plaintiffs stated a direct claim under *Gentile*.

On interlocutory appeal, the defendants-below/appellants argued that the plaintiffs' claims were derivative under *Tooley*, and that *Gentile* should be overruled because it "contradicts and undermines long-standing case law, complicates real-world commercial transactions, and is superfluous given existing legal remedies." Addressing the importance of *stare decisis* and emphasizing that "precedent should not be lightly cast aside," the Delaware Supreme Court nevertheless agreed with the defendants-below/appellants, engaging in a detailed history of the court's decisions concerning direct and derivative claims, and ultimately concluding that "the corporation overpayment/dilution *Gentile* claims … are exclusively derivative under *Tooley* and that *Gentile* … should be overruled." It therefore reversed the Court of Chancery's decision, "not because the Court of Chancery erred, but rather, because the Vice Chancellor correctly applied the law as it existed, recognizing that the claims were exclusively derivative under *Tooley*, and that he was bound by *Gentile*."

Key Takeaways

Both *Tri-State* and *Brookfield* provide important insight into how the Delaware courts will evaluate derivative claims going forward. Carefully acknowledging the importance of *stare decisis* and past precedent, these decisions embody the adaptability and willingness to evolve the common law to meet new developments that litigants and practitioners have come to expect from the Delaware courts.

Under *Tri-State*, the refined three-part demand futility test is now the "universal test for assessing whether demand should be excused." While determining whether the *Aronson* test or *Rales* test controls is no longer necessary, cases properly applying *Aronson* and *Rales* remain good law.

Brookfield, on the other hand, overrules the Delaware Supreme Court's prior decision in *Gentile*, clarifying that claims challenging corporate overpayment/dilution, where economic voting value and voting power is transferred from minority stockholders to a controlling stockholder, will now be considered exclusively derivative.