



Executive Compensation and Benefits Alert

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A Pipe Is Indeed a Pipe: Delaware Court of Chancery Provides Important Guidance to Companies by Dismissing Excessive Director Pay Case

On October 30, 2019, the Delaware Court of Chancery struck a major blow against the plaintiffs’ bar’s efforts to lower the statutory hurdle to maintaining stockholder derivative claims. A stockholder of Ultragenyx Pharmaceutical Inc. claimed that the company’s board of directors had awarded its non-employee directors excessive pay. Under applicable Delaware law, a stockholder asserting such a claim has two mutually exclusive options: make a pre-suit demand on the board or plead with particularity the reason it would have been futile to do so. A stockholder who makes a pre-suit demand may not later claim demand futility, but instead must make the more difficult claim that the board wrongfully refused the demand, which is essentially a business judgment analysis. The Chancery Court previously has noted that pleading demand futility is a steep road, but that making a pre-suit demand is “steeper yet.”

Some members of the plaintiffs’ bar have sought — as the Chancery Court put it — to “cover all the bases” by sending a stockholder communication within the meaning of the applicable Delaware rule for a demand, but later claiming that they did not make a demand. As part of that tactic, the plaintiff’s counsel sent a pre-suit letter to the company’s board “suggesting” that the board take remedial action, while expressly stating that the letter was not a demand within the meaning of the applicable Delaware rule. The court likened this approach to a famous 1929 surrealist painting by René Magritte depicting a smoking pipe above the caption, “This is not a pipe.”

In *Ultragenyx*, upon receipt of the letter, the company’s board treated it as a demand and conducted an investigation into the allegations and concluded not to pursue them on behalf of the company. The defendants (the company and its directors) subsequently moved to dismiss the complaint because the plaintiff had failed to plead wrongful demand refusal. The court agreed that the pre-suit letter was in fact a pre-suit demand. Revealing what it called the “proverbial wolf in sheep’s clothing,” the court found that the pre-suit letter was not “a harmless letter seeking prospective board action” but rather “something with far more legal bite – a pre-suit demand.” As such, the court found that the board’s determination that it would be in the best interests of the company not to authorize commencement of a civil action or changes in its board compensation practices was a proper exercise of its fiduciary duties and entitled to the protection of the business judgment rule.

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The court went on to hold that when considering whether a communication is a demand, the court is not constrained by “the subjective intent of the sender,” there are no “magic words” establishing whether a communication is a demand and Delaware’s prohibition on stockholders both making a demand and pleading demand futility “would become a virtual nullity if a stockholder could avoid a judicial determination that pre-suit demand was made by simply stating ‘this is not a demand’ in [a] pre-suit communication to a board.”

The opinion stands as a clear rejection of plaintiffs’ counsel using a tactical, “stock form” letter to pressure a board to settle baseless nonemployee director compensation claims.

Skadden represented Ultragenyx and its board in the case.

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