Court of Chancery Continues to Reject Demand Futility Claims Post-*Zuckerberg*

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In September 2021, in *United Food and Commercial Workers Union v. Zuckerberg*, the Delaware Supreme Court embraced the Court of Chancery's suggestion that the analysis for evaluating demand futility in derivative cases should be streamlined. Rather than employing the prior *Aronson v. Lewis or Rales v. Blasband* standards, the Supreme Court set forth a new, three-part test that "is consistent with and enhances" those standards, so that "cases properly construing *Aronson, Rales*, and their progeny remain good law."[1]

Under *Zuckerberg*, when ruling on a motion to dismiss where the plaintiff asserts demand futility, Delaware courts will examine whether a director: (1) received a material personal benefit from the alleged misconduct; (2) would face a substantial likelihood of liability on any of the claims that would be the subject of the litigation demand; or (3) lacks independence from someone who received a material benefit from the alleged misconduct, or would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand. If the answer to any of those questions is "yes" for at least half of the members of the board that would be considering the demand, then demand would be excused as futile. (See our September 28, 2021, client alert, "Delaware Supreme Court Issues Two Opinions Simplifying Delaware Law on Derivative Claims.")

Since *Zuckerberg*, practitioners, companies and directors have watched to see how the new standard was applied, and if it would alter Delaware's traditional approach to evaluating demand futility, including deference to directors' ability to make decisions about litigation brought in the company's name. In a series of opinions, discussed below, the Court of Chancery has applied the *Zuckerberg* formulation to evaluate director disinterest and independence and found that a demand would not have been futile.

In re Vaxart, Inc. Stockholder Litigation (November 30, 2021)

In September 2020, plaintiffs filed a stockholder class action derivatively on behalf of Vaxart, Inc., a small biotechnology company that was developing a vaccine for COVID-19 in the early stages of the pandemic. Plaintiffs challenged amendments to two warrant agreements between the company and a purported controlling stockholder, Armistice, which, "[i]n effect, … enabled the stockholder to exercise and dispose of the warrant shares faster than under the terms of the original warrants."[2]

Plaintiffs alleged that the Vaxart board and Armistice had advance knowledge of the company's participation in a non-human primate study sponsored by the federal government's Operation Warp Speed vaccine development program. Plaintiffs alleged that the board amended these documents to the benefit of directors and Armistice in advance of a jump in Vaxart's stock price that occurred on announcement of the participation.

The court first found that Armistice was not a controller at the time of the challenged transaction, because at the time it did not own more than 50% of Vaxart's voting power or exercise actual control over Vaxart. The Court of Chancery then applied the *Zuckerberg* test and "conclude[d] that Plaintiffs have failed to establish that at least half the members of the

[1] *United Food & Commercial Workers Union & Participating Food Indus. Employers Tri-State Pension Fund v. Zuckerberg*, 262 A.3d 1034, 1059 (Del. Sept. 23, 2021).

[2] *In re Vaxart, Inc. Stockholder Litig.*, 2021 WL 5858696, at *1 (Del. Ch. Nov. 30, 2021).

Demand Board were incapable of fairly and impartially considering a litigation demand as to the Warrant Amendments."[3]

Whether a majority of the demand board was able to impartially consider a demand turned on the disinterest and independence of two directors, Wouter Latour and Andrei Floroiu. The court rejected the allegations that Latour was not independent from the Armistice directors because the Armistice directors supported Latour's stock option grant supposedly in exchange for Latour's support of the Warrant Amendments and the Armistice directors allowed Latour to remain on the board after his resignation as CEO and approved his separation package.

With respect to Floroiu, the court rejected the claim that he was indebted to the Armistice directors because the Armistice directors appointed him as CEO of Vaxart and approved his "enormously lucrative stock options." In doing so, the court reiterated that, "[w]ithout more, pleading that a board of directors elevated an executive to her current role or approved her compensation is insufficient to establish that the recipient is 'beholden' to any director who approved that decision."

Turning to the third *Zuckerberg* prong, the court found that the complaint failed to plead that a majority of the board would receive a material benefit or face a substantial risk of personal liability for the claims related to the warrant amendments, because the board did not amend the warrant agreements in bad faith, since such amendments "were hardly a gift; their exercise 'increase[d] the Company's cash on hand by $5 million.'"[4]

In re Kraft Heinz Company (December 15, 2021)

In July 2019, stockholders began filing derivative complaints on behalf of The Kraft Heinz Company related to the sale by 3G Capital, Inc. of a 7% stake in Kraft, resulting in proceeds of over $1.2 billion for 3G, which owned 24% before the sale.

Plaintiffs alleged that 3G, entities affiliated with it and certain dual fiduciaries of 3G and Kraft breached their fiduciary duties to Kraft stockholders by "either approv[ing] 3G's stock sale based on adverse material nonpublic information or allow[ing] 3G to effectuate the sale to the detriment of Kraft Heinz and its non-3G stockholders."[5]

In analyzing demand futility, the Court of Chancery applied the *Zuckerberg* "universal test" to "count heads" to determine whether a majority of the Kraft board of directors were disinterested and independent. The court analyzed only six of the 11 directors, as defendants conceded that three 3G-affiliated directors could not exercise impartial judgment regarding a demand, and plaintiffs allowed that two other directors were independent and disinterested.

The court focused on just the third prong of *Zuckerberg* (lack of independence) because no director was alleged to have sold Kraft stock during the relevant period or personally benefitted from 3G's sale. The court ultimately concluded that plaintiffs failed to plead particularized facts sufficient to create reasonable doubt about the independence of four of the six examined directors.

In particular, the court rejected plaintiffs' argument that two directors were not independent because both had close ties and affiliations with Warren Buffett and Berkshire Hathaway Inc., which has a "close co-investing relationship with 3G." One of those directors had worked as a financial assistant to Buffett, served as a director and CEO of Berkshire Hathaway subsidiaries and Buffett allegedly walked her down the aisle at her wedding in 2013.[6]

The court explained that plaintiffs' "transitive theory of independence," disqualifying directors tied to Berkshire Hathaway because of its relationship to 3G, failed for several

[3] *Id.* at *18. However, the court did not determine whether demand was futile concerning plaintiffs' derivative unjust enrichment claim, which alleged that directors breached their fiduciary duties by issuing spring-loaded options in violation of the company's 2019 equity incentive plan. The court requested supplemental briefing on that issue.

[4] *Id.* at *22.

[5] *In re Kraft Heinz Co. Derivative Litig.*, 2021 WL 6012632, at *1 (Del. Ch. Dec. 15, 2021).

[6] *Id.* at *8.

reasons, including that the complaint failed to plead particularized allegations supporting a conclusion that either director felt subject to 3G's dominion or beholden to 3G based on its history of co-investing with Berkshire.

Simons v. Brookfield Asset Management Inc. (January 21, 2022)

In 2021, plaintiff filed a stockholder class action derivatively on behalf of GrafTech International, Ltd. challenging the fairness of the price GrafTech paid to repurchase stock from its controlling stockholder, Brookfield Asset Management, Inc. After the share repurchase, and seven months after plaintiff served a Section 220 books and records demand — but *before* plaintiff filed suit — GrafTech's board voted to expand from eight to nine seats and filled the vacancy with an independent director.

"To improve his odds, the plaintiff [sought] to exclude from the head-counting analysis" the independent director. However, the court concluded that GrafTech's certificate of operation and stockholder agreement permitted the board's expansion and dismissed plaintiff's claim that it was a breach of fiduciary duty, saying that the timing of the director's appointment "does not render it reasonably conceivable that the directors breached their fiduciary duties by appointing a concededly independent director to the Board."[7]

Ultimately, the court concluded that demand was not futile under *Zuckerberg* because no outside director (i) received a material personal benefit from the transaction, (ii) faced a substantial likelihood of liability or (iii) lacked independence. Notably, the court specifically held that one director did not lack independence simply because he was retired and the $140,000 he received annually in cash and stock as director fees were his sole source of income, because that was not excessive.

[7] *Simons v. Brookfield Asset Mgmt. Inc.*, 2022 WL 223464, at *9 (Del. Ch. Jan. 21, 2022).

In re Camping World Derivative Litigation (January 31, 2022)

Following disclosures in 2017 by Camping World Holding, Inc. about its integration of stores purchased in bankruptcy from Gander Mount Company, plaintiffs filed a derivative action for breach of fiduciary duty and unjust enrichment. Plaintiffs alleged that a majority of the Camping World board was not independent because they faced a substantial likelihood of liability based on three claims: (i) a *Brophy* claim against certain directors and officers "selling Camping World stock on the basis of the knowledge of improper information … before that information was revealed to the Company's stockholders"[8]; (ii) a related disclosure claim for issuing false and misleading disclosures; and (iii) a *Caremark* claim for the board allegedly disregarding its oversight duties.

Conducting the *Zuckerberg* test on a director-by-director and claim-by-claim basis, the Court of Chancery held that demand was not futile because a majority of Camping World's nine-member board could exercise independent and disinterested judgment in responding to a demand.

Plaintiffs did not challenge the independence of four directors, and two were assumed to be interested, so the court's examination was limited to two outside directors, K. Dillon Schickli and Andris Baltins. The court found that Schickli did not lack independence simply because he was appointed to the board by an alleged controller or was compensated approximately $200,000 per year for his services. The court held that plaintiffs failed to adequately plead materiality. The court also stated that the fact that Schickli served as the COO 25 years earlier for a company controlled by an assumed interested director "cannot, by itself, 'create a disabling interest' today."[9]

[8] *In re Camping World Holdings, Inc. S'holder Deriv. Litig.*, 2022 WL 288152, at *5 (Del. Ch. Jan. 31, 2022).

[9] *Id.* at *18.

With the determination that Schickli was able to consider a demand impartially, the court held that a majority of the board was disinterested and independent for demand futility purposes, and therefore did not reach the issue of whether Baltins lacked independence because he was a partner in a law firm that previously received fees from Camping World.

Takeaways

- Under the new *Zuckerberg* test, Delaware courts no longer have to decide whether the *Aronson* or *Rales* tests apply, but will instead apply a combined three-part test to "count heads" to determine whether a majority of directors that would be evaluating a demand are capable of doing so.
- Delaware courts continue to scrutinize directors' independence carefully when transactions are challenged, and have not strayed from traditional Delaware law in the demand context. Recent cases applying *Zuckerberg* have reiterated long-standing Delaware law that simply being appointed by a controlling stockholder does not establish that the director lacks independence from the controlling stockholder. Likewise, the receipt of standard directors fees, without more, is insufficient to render a director interested.
- Delaware courts continue post-*Zuckerberg* to examine whether directors face a substantial likelihood of liability. Even if one or more directors potentially do, the key for the demand futility analysis will be whether a *majority* of the directors face a substantial likelihood of liability, or are otherwise unable to consider a demand because they are not independent from someone who does.
- As before *Zuckerberg*, Delaware courts are not hesitant to dismiss derivative claims on demand futility grounds if a majority of directors would be able to impartially consider a demand.

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