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The Delaware Supreme Court Adopts a Universal Demand-Futility Test in Facebook Investors' Derivative Suit

On September 23, 2021, the Delaware Supreme Court affirmed the Chancery Court's dismissal of a derivative suit that a pension fund (Tri-State) had brought against Facebook's board of directors. Tri-State's suit was dismissed because it had failed to make a pre-suit demand on the nine-member board to bring action on behalf of the company or to "plead with particularity" facts that would establish that such a demand would be futile. In reaching such a conclusion, the Supreme Court combined the demand futility factors under the *Aronson* and *Rales* tests and adopted a stringent three-part universal demand-futility test.

In 2016, a number of shareholder class actions were filed challenging Facebook's reclassification of voting shares allegedly in order to maintain Mark Zuckerberg's voting power. Facebook abandoned the reclassification on the eve of trial in the class actions. Tri-State filed a derivative action in 2018 against Zuckerberg and other directors seeking to recoup the money that Facebook had spent defending and settling the reclassification class actions. In that derivative action, Tri-State alleged that six of Facebook's directors, including Zuckerberg, had breached their fiduciary duties of care and loyalty by improperly approving the reclassification.

Tri-State did not make a litigation demand before filing its derivative action, alleging that demand was excused as futile. In support of its futility argument, Tri-State argued the reclassification approval was not protected by the business judgment rule because it was not "fully informed" or "duly considered" and because a majority of the directors lacked independence from Zuckerberg. (Opinion (Op.) at 22.)

The demand requirement exists to ensure "'that a stockholder exhausts his intracorporate remedies,' 'provide[s] a safeguard against strike suits,' and 'assure[s] that the stockholder affords the corporation the opportunity to address an alleged wrong without litigation and to control any litigation which does occur.'" (Op. at 19 (quoting *Lenois v. Lawal*, 2017 WL 5289611, at *9 (Del. Ch. Nov. 7, 2017) (internal citations omitted).) Analyzing the complaint under Delaware Court of Chancery Rule 23.1, a plaintiff must meet "stringent requirements of factual particularity" in showing that making the demand is futile. (Op. at 20.)

Under the *Aronson* test,[1] a plaintiff seeking to challenge a decision by the same board that would consider a litigation demand was required to raise a reasonable doubt that (1) the directors are disinterested and independent, or (2) the challenged transaction was the product of valid business judgment. (Op. at 20-21.) Under the *Rales* test,[2] which applied in all other circumstances, a plaintiff was required to plead with particularity that there existed a "reasonable doubt" that a majority of the board at the time the complaint was filed could have properly exercised its independent and disinterested business judgment in responding to a demand. (Op. at 21).

In the Facebook case, the Delaware Supreme Court adopted a universal demand futility test that blended the *Aronson* and *Rales* tests. (Op. at 36-37.) The refined test requires the court to determine the following in relation to each of the individual directors:

(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 would be 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 would be 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."

(Op. at 41.) The court stated that "[i]f the answer to any of the questions is 'yes' for at least half of the members of the demand board, then demand is excused as futile" and that is the end of the inquiry. (*Id.*)

Applying this refined test, the Delaware Supreme Court affirmed the Chancery Court's dismissal of Tri-State's complaint because it failed to adequately plead demand futility. Tri-State conceded that two directors could have impartially considered the demand, and Facebook did not argue that three (Zuckerberg and two others) could have impartially considered the same. (Op. at 41-42.) Tri-State therefore was required to allege that two of the remaining directors could not impartially consider the demand. Tri-State failed to meet this burden because (i) it conceded that the remaining directors did not have a personal interest in the reclassification, (ii) it had not alleged that the remaining directors committed a breach of their fiduciary duties that was not exculpated by the provisions of Facebook's corporate charter, and (iii) it was unable to adequately plead that the remaining directors lacked independence from Zuckerberg. (*Id.* at 42-43.)

With this precedential opinion, the Delaware Supreme Court has now refined the standard for determining demand futility in all cases and has made it more difficult for investors and stockholders to sue on behalf of Delaware corporations without first making a litigation demand on the board.

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[1] *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984).

[2] *Rales v. Blasband*, 634 A.2d 927 (Del. 1993).

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