CORPORATE LITIGATION:

SHAREHOLDER DERIVATIVE ACTIONS AND DEMAND FUTILITY

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A cardinal precept of Delaware law is that directors, rather than shareholders, manage the business and affairs of the corporation. In the context of shareholder requests that the company pursue litigation, the decision whether to pursue litigation on behalf of the company generally resides with the board as an exercise of business judgment. A stockholder lacks standing to bring suit on the company's behalf unless the stockholder (i) has demanded that the directors pursue the corporate claim and the demand is wrongfully refused; or (ii) purports to initiate litigation on behalf of the company and alleges with particularity why pre-suit demand is excused as futile.

Delaware law features two tests to determine the sufficiency of a derivative complaint alleging demand futility. The applicable test depends on the composition of the board at the time of the complaint and whether a specific board decision is challenged. Known as the Rales test, where a putative derivative plaintiff chooses the demand futility path and no specific board decision is challenged, in order to avoid dismissal the shareholder must point to particularized allegations in its complaint raising reasonable doubt that a majority of the board could impartially consider a demand to sue.

Last month, Delaware Chancellor Andre G. Bouchard in *Teamsters Union 25 Health Services & Insurance Plan v. Baiera* held that a decision made by a board committee composed of a minority of the board will not be evaluated as a decision of the full board for demand futility purposes. Consequently, Delaware's Rales test, not the Aronson test applicable to a board decision, applies when evaluating whether it would be futile to make a demand on the board to pursue litigation challenging the committee's decision.[1] *Baiera* also illustrates that the plaintiff's challenges in establishing demand futility are not lessened merely by challenging a related party transaction with a large equity stakeholder.

Delaware's Standards

Where a board decision is challenged and the directors who made the decision alleged to have harmed the company are the same as those to whom plaintiffs would make a pre-suit demand, Delaware courts apply the two-pronged test articulated in 1984 by the Delaware Supreme Court in *Aronson v. Lewis*. Under *Aronson*, demand is excused only where the complaint alleges particularized facts creating reasonable doubt that (1) the directors are disinterested and independent on the subject or (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.[2]

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Several years after *Aronson*, the Delaware Supreme Court questioned the utility of the Aronson test in cases "where the board that would be considering the demand did not make a business decision which is being challenged in the derivative suit."[3] According to the court in *Rales v. Blasband*, such a situation may arise "in three principal scenarios: (1) where a business decision was made by the board of a company, but a majority of the directors making the decision have been replaced; (2) where the subject of the derivative suit is not a business decision of the board; and (3) where...the decision being challenged was made by the board of a different corporation."

Under the Rales test, a complaint alleging demand futility must plead sufficient particularized facts to create reasonable doubt about the ability of the board that would be addressing the demand (i.e. the board at the time the complaint was filed) to consider the demand impartially.

Under either test, the plaintiff "must impugn the ability of at least half of the directors in office when it initiated [the action]...to have considered a demand impartially."[4] Both *Rales* and *Aronson* require a court to evaluate the sufficiency of a complaint's allegations of alleged directorial bias.

'Baiera'

Chancellor Bouchard's decision in *Baiera* illustrates application of the factors Delaware courts consider in determining whether demand futility was adequately pleaded under these tests. The underlying transaction was a services agreement between Orbitz Worldwide, Inc., an online travel company, and Travelport Limited, a provider of transaction processing services to travel companies. As a related party transaction, Orbitz's charter required approval of the agreement by the Orbitz board's audit committee. The plaintiff, an Orbitz shareholder, alleged that the agreement was unfair to Orbitz because Travelport's significant equity interest in Orbitz allowed it to obtain preferential terms. Plaintiff asserted putative derivative claims for breaches of fiduciary duty against both Travelport, as Orbitz's asserted controlling shareholder, and Orbitz's board of directors. Citing the plaintiff's failure to make pre-suit demand, Orbitz moved to dismiss the derivative claims.

As an initial matter, the Chancery Court considered whether demand futility should be assessed under the Aronson or Rales test. Plaintiff argued that even though only a third of the nine-member Orbitz board, the three-member audit committee, was directly involved in approving the Travelport agreement, the remaining directors "would have been involved in" approving the deal, such that *Aronson* would apply.

The court disagreed, finding that in the face of a charter provision requiring audit committee approval, the plaintiff's proposed "inference of full board approval...amounts to little more than speculation."[5] The court indicated that, as a related party transaction, the audit committee's charter gave that committee responsibility to review and approve the agreement. The court found an inference of full board participation "particularly inappropriate" in light of the plaintiff's failure pre-suit to employ the statutory right Delaware grants shareholders to inspect corporate books and records.[6]

Noting that an examination of the records surrounding the negotiation and approval of the Travelport transaction may have shed light on whether the full board was involved in the transaction's approval, the court declined "to speculate over a factual matter that was well within Plaintiff's control to determine through basic due diligence." Absent evidence that the directors who approved the Travelport deal were the same as those who would have considered demand, the court found the Rales test applicable.

Turning to its analysis of demand futility under *Rales*, under which the complaint needed to plead facts indicating that a majority of the directors "could not have exercised disinterested business judgment in responding to a demand," the court rejected three arguments advanced by the plaintiff as to why demand was futile. Plaintiff first argued that a majority of the nine members of the board were either interested in the transaction or were not independent from Travelport.

Given the complaint's concession that four of Orbitz's nine directors were independent, the court needed to determine that only one of the remaining five directors was independent in order to dismiss the plaintiff's argument. The court focused on director Kenneth Esterow, who had spent 16 years as an executive of Travelport (or Travelport's former parent company) before being appointed to the Orbitz board in 2011. The complaint alleged that Esterow's "long-term and high-level employment with Travelport" raised a reasonable doubt as to his independence from Travelport.

Noting that "[i]n the demand futility context, directors are 'presumed to be independent'"—i.e., that their decisions are "'based on the corporate merits of the subject before the board rather than extraneous considerations or influences'"—the court held that a former employment relationship that ended almost three years before the action was filed is, by itself, insufficient to question the director's presumptive independence.[7] Chancellor Bouchard continued that even if it assumed that Esterow's directorship were "a 'loyalty appointment' by Travelport, the mere fact that Travelport, an alleged controlling stockholder, 'played some role in the nomination process should not, without additional evidence, automatically foreclose a director's potential independence.'"[8]

Moreover, the court disagreed that lack of independence could be derived from a company proxy statement that did not identify a particular director as "independent" under New York Stock Exchange (NYSE) Rules. Under NYSE Rule 303A.02(b)(i), a director is automatically considered non-independent if, within the last three years, that director has been an employee of the "listed company," defined to include a parent entity owning over 50 percent of the company. The court explained, however, that "[u]nlike the NYSE Rules, Delaware law does not contain bright-line tests for determining independence but instead engages in a case-by-case fact specific inquiry based on well-pled factual allegations." Under this regime, the court held, "the peculiarities of the NYSE Rules" regarding director independence "carr[y] little weight" for determining demand futility.

The court also rejected the second argument for demand futility—that the directors on Orbitz's audit committee approved the agreement in bad faith. The court explained that under Delaware law, bad faith can be demonstrated "by establishing that a director's decision was 'so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith'"—a "high pleading standard" to meet.[9] It was not sufficient to allege that the directors acted in bad faith because the agreement's "material terms" "deviate[d] from market standards and are patently unfair to Orbitz yet highly beneficial to Travelport." The complaint did not plead with particularity facts that would allow the court to reasonably infer that the agreement was "so facially unfair as to constitute a lack of good faith"—indeed, it did not specify any financial terms of the agreement.

Finally, the court considered and rejected the argument that Travelport's role as both a significant shareholder and deal counterparty excused demand. As Chancellor Bouchard reasoned, the "logical extension of this argument is that demand would be excused as a matter of law whenever a transaction between a corporation and its putative controlling stockholder implicates the entire fairness standard." This approach, explained the court, is inconsistent with precedent that "make[s] plain [that] the demand futility test under Delaware law," whether under *Aronson* or *Rales*, "focuses exclusively on whether there is a reasonable doubt that the directors could impartially respond to a demand."[10] Thus, the opinion clarifies that even where a controlling shareholder is party to a transaction with the company, so that the entire fairness standard may govern the fiduciary duty claim, the demand futility inquiry retains its "director-based focus."

Significance of 'Baiera'

Under Delaware law, the determination of director impartiality for demand futility purposes is a director-by-director inquiry that focuses on the ability of each of the directors constituting a majority of the board to evaluate a demand. *Baiera* clarifies that "neither the presence of a controlling stockholder nor allegations of self-dealing by a controlling stockholder changes the director-based focus of the demand futility inquiry."

Baiera further highlights that because director independence is presumed, putative derivative plaintiffs face a steep burden in seeking to plead non-independence for demand futility purposes. As the court held, a director's former employment relationship with the counterparty to the transaction or the fact that an alleged controlling shareholder may have been involved in the director's nomination are not, in themselves, sufficient to overcome the presumption of independence. In addition, while several pre-Baiera cases addressing claims of demand futility accorded some weight, among other factors, to a director's independence under the NYSE Rules, the Baiera decision clarifies that the NYSE Rules on director independence are not determinative of whether directors are capable of considering demand impartially.[11]

Notably, while the earlier decisions used the NYSE Rules to support their findings that the directors at issue were independent, the situation addressed by *Baiera* was the reverse—the company's disclosure in that case indicated that the director was not independent under the NYSE Rules. *Baiera* underscores, therefore, that given the strong presumption of director independence, pleading non-independence will require more than reliance on the NYSE Rules.

Endnotes:

[1] 2015 WL 4192107 (Del. Ch. July 13, 2015).

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

[3] *Rales v. Blasband*, 634 A.2d 927, 933-34 (Del. 1993).

[4] *Baiera*, 2015 WL 4192102, at *9.

[5] Id.

[6] Id. at *10. See 8 Del. C. § 220.

[7] Id. at *11 (quoting *Beam v. Stewart*, 845 A.2d 1040, 1055 (Del. 2004); *Aronson*, 473 A.2d at 816).

[8] Id. (citations omitted).

[9] Id. at *13 (citations omitted).

[10] Id. at *17 (referencing *Aronson*, Beam, and Rule 23.1).

[11] See, e.g., *In re MFW Shareholders Litig.*, 67 A.3d 496, 510, 512 (Del. Ch. 2013) (acknowledging that independence under the NYSE Rules is not determinative of independence under Delaware law in certain circumstances, but noting that the NYSE Rules "are a useful source for this court to consider when assessing an argument that a director lacks

independence" and discussing the NYSE Rules to bolster its conclusion that a particular director was independent); *In re J.P. Morgan Chase & Co. Shareholder Litig.*, 906 A.2d 808, 823 (Del. Ch. 2005) (discussing the NYSE Rules in reaching its conclusion that the director was independent).
