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Memorandum

Recent Delaware Derivative Stockholder Litigation Developments

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This memorandum reviews two recent Delaware Supreme Court opinions that reexamine the standards governing the ability of stockholders to pursue derivative claims in the name of the company against corporate directors and officers, as well as several recent decisions from the Delaware Chancery Court that continue to explore the contours of "*Caremark* claims" brought against corporate boards for failure of the duty of oversight in connection with negative corporate events.

In *Brookfield Asset Management, Inc. v. Rosson*, 2021 WL 4260639 (Del. Sept. 20, 2021), the Delaware Supreme Court overruled the concept of "dual" claims established by *Gentile v. Rossette*—*i.e.*, situations where there could be both direct claims litigable by stockholders and derivative claims subject to control of the company's board, and in *UFCW Union & Participating Food Industry Employers Tri-State Pension Fund v. Zuckerberg*, 2021 WL 4344361 (Del. Sept. 23, 2021), the Supreme Court articulated a refined test for the pleading of "demand futility"—typically the threshold test before a shareholder can take control of a derivative claim.

The Delaware Court of Chancery has also recently issued several opinions concerning claims that boards failed to oversee company operations under standard established by *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996) ("*Caremark* claims"). While oversight liability under *Caremark* is "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment," these recent developments show that while the theory presents obstacles they are not insurmountable. This area has been closely watched since the Delaware Supreme Court's 2019 decision in *Marchand v. Barnhill*, 212 A.3d 805 (Del. 2019), which allowed a *Caremark* claim to proceed against Blue Bell Creameries' board related to a listeria outbreak resulting in three customer deaths. In *Firemen's Retirement System of St. Louis v. Sorenson*, 2021 WL 4593777 (Del. Ch. Oct. 5, 2021), Vice Chancellor Lori Will dismissed a derivative case related to a cybersecurity breach of hotel customer data, holding that none of the current board members faced a substantial likelihood of liability for a non-exculpated claim. By contrast, in *In re The Boeing Co. Derivative Litigation*, 2021 WL 4059934 (Del. Ch. Sept. 7, 2021), Vice Chancellor Morgan Zurn denied motions to dismiss a derivative claim concerning Boeing's directors' oversight duties brought in the wake of two fatal plane crashes, finding that plaintiffs pled a substantial likelihood of liability for both failure to establish a reporting system for airplane safety and ignoring red flags related to airplane safety.

1. *Brookfield Asset Management, Inc. v. Rosson*

In *Brookfield Asset Management, Inc. v. Rosson*, the Supreme Court overruled *Gentile v. Rossette*, which permitted stockholders to bring direct claims against controlling stockholders for diluting the value of their shares, even though dilution claims are typically considered derivative under Delaware law.[1] Since 2006, *Gentile* had stood as an exception to Delaware's test for derivative and direct standing established by *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*

Background and Procedural History. In 2019, plaintiff stockholders alleged that Brookfield Asset Management, the controlling stockholder of a green energy company had steered the company into a private placement for inadequate value, which diluted the stockholders' financial and voting interest. Plaintiffs filed a derivative and putative class action complaint against all defendants for breach of fiduciary duty. Defendants moved to dismiss plaintiffs' direct claims on the basis that they were exclusively derivative. Subsequently, Brookfield's subsidiary acquired the remaining public shares of the company and the Chancery Court dismissed the derivative counts because plaintiff stockholders lost ownership of their shares in the acquisition.

The Court of Chancery denied defendants' motion to dismiss, determining that it was bound by *Gentile* and that plaintiffs had standing to assert direct claims under *Gentile* because the claims were predicated on facts similar to those in *Gentile*. Defendants sought an interlocutory appeal.

The Supreme Court Determined That *Gentile* Is Contradictory and Superfluous. The Delaware Supreme Court unanimously overturned *Gentile*, holding that it carved out a contradictory and superfluous exception to the test establishing whether stockholders' claims are direct or derivative established by *Tooley*. The Court agreed with defendants that certain aspects of *Gentile* were in tension with *Tooley*. Specifically, *Gentile*'s conclusion that the harm to the stockholders running from the private placement was independent of any injury to the corporation. The Court pointed out that the private placement allegedly harmed the company by issuing shares for an unfairly low price and also harmed the stockholders indirectly through dilution. The Court determined that, therefore, the harm to the stockholders was not independent of the harm to the company, but rather "flowed indirectly" to them in proportion to and via their shares. The Court determined that under *Tooley*, the alleged overpayment in stock and consequent dilution of minority interest fell "neatly" into *Tooley*'s derivative category.

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[1] In *Gentile*, the Court stated that a breach of fiduciary duty claim is both derivative and direct "where: (1) a stockholder having majority or effective control causes the corporation to issue 'excessive' shares of its stock in exchange for assets of the controlling stockholder that have a lesser value; and (2) the exchange causes an increase in the percentage of the outstanding shares owned by the controlling stockholder, and a corresponding decrease in the share percentage owned by the public (minority) shareholders." The Court explained that while such a claim, by definition, is derivative, "the public (or minority) stockholders also have a separate, and direct, claim arising out of that same transaction."

2. *UFCW Union & Participating Food Industry Employers Tri-State Pension Fund v. Zuckerberg*

In *UFCW Union*, the Delaware Supreme Court adopted a refined three-part demand futility test that combines elements of the tests articulated in *Aronson v. Lewis*[2] and *Rales v. Blasband*.[3] The Court's decision affirmed the dismissal of a Facebook stockholder's derivative suit against current and former directors seeking to recover the litigation fees that Facebook spent defending a withdrawn stock reclassification plan proposed by entrenched CEO Mark Zuckerberg. The Court of Chancery dismissed the suit, concluding that a majority of the board at the time the lawsuit was filed was disinterested, independent and capable of considering a demand and, therefore, that demand was not excused as futile.

Background and Procedural History. In 2016, Facebook proposed a stock reclassification plan that would allow Zuckerberg to liquidate a portion of his shareholdings while retaining his controlling interest in Facebook. Stockholders sued in the Chancery Court alleging that the board breached their fiduciary duties by negotiating and approving the reclassification. Facebook later withdrew the proposal, and settled the underlying litigation, including for payment of attorneys' fees to plaintiffs' counsel of over $68 million. After the settlement, another Facebook stockholder filed a derivative suit seeking to recover the Facebook funds spent in connection with the first class action lawsuit. Plaintiff in this case did not make a derivative demand on the board, pleading that such a demand was futile. The Court of Chancery granted defendants' motion to dismiss. In reaching this conclusion, Vice Chancellor Laster applied a three-part demand-futility test that blended *Aronson* and *Rales*. Plaintiff appealed.

Exculpated Claims Do Not Expose Directors to a Substantial Likelihood of Liability. In its unanimous decision, the Delaware Supreme Court affirmed the Chancery Court's dismissal, adopted Vice Chancellor Laster's three-part test and agreed with his findings.

The Court explained that *Aronson*'s second prong "focuses on whether the derivative claims would expose directors to a substantial likelihood of liability." The Court held that exculpated claims do not satisfy that standard because they do not expose directors to a substantial likelihood of liability. The Court also noted that plaintiff did not plead with particularity that a majority of the demand board lacked independence.

The Court explained that the enactment of Section 102(b)(7) of the Delaware General Corporation Law and other corporate law developments since *Aronson* "have weakened the connection between rebutting the business judgment standard and exposing directors to a risk that would sterilize their judgment with respect to a litigation demand." The Court also pointed out that the *Aronson* test has proven difficult to apply in many contexts, such as

[2] "Under *Aronson*, demand is excused as futile if the complaint alleges particularized facts that raise a reasonable doubt that (1) the directors are disinterested and independent, or (2) the challenged transaction was otherwise the product of a valid business judgment."

[3] "Under *Rales*, demand is excused as futile if the complaint alleges particularized facts creating a reasonable doubt that, as of the time the complaint is filed, a majority of the demand board could have properly exercised its independent and disinterested business judgment in responding to a demand."

where there is board turnover. The Supreme Court determined that Vice Chancellor Laster's combined test helps to address those issues.

Going forward, "courts should ask the following three questions on a director-by-director basis when evaluating allegations of demand futility:

> (i) whether the director received a material personal benefit from the alleged misconduct that is the subject of the litigation demand;
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> (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
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> (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."

If 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. The Court noted that it is no longer necessary to determine whether the *Aronson* test or the *Rales* test governs a complaint's demand-futility allegations.

3. *Firemen's Retirement System of St. Louis v. Sorenson*

In *Firemen's Retirement System of St. Louis v. Sorenson*, the Court of Chancery dismissed a derivative case related to a cybersecurity breach of Marriott customer data, holding that none of the current board members faced a substantial likelihood of liability for a non-exculpated claim. After acknowledging the growing risks posed by cybersecurity threats, the court stated that these risks do not "lower the high threshold that a plaintiff must meet to plead a *Caremark* claim." The court determined that the allegations did not meet this threshold because plaintiff did not show that the directors completely failed in their oversight responsibilities, ignored known compliance violations or failed to remediate prior cybersecurity failures.

Background. In 2018, Marriott had discovered a substantial data security breach exposing guests' personal information. The cyberattack had begun in 2014 on reservation database of Starwood Hotels and Resorts, which Marriott acquired in 2016. A Marriott stockholder plaintiff brought a derivative lawsuit against several executives and directors, alleging claims related to periods both before and after the Starwood acquisition.

Plaintiffs Failed to Plead Demand Futility; Did Not State a *Caremark* Claim. The court concluded any claim based on pre-acquisition due diligence was time-barred. The court then determined that any remaining claims fell short of pleading a breach of the directors' duty of loyalty. The court stated that demand was not excused because none of the director defendants faced a substantial likelihood of liability on a non-exculpated claim and none of the directors faced a substantial likelihood of liability under *Caremark*. Under *Caremark*, a plaintiff must allege particularized facts that satisfy one of the necessary conditions for director oversight liability,

either that “the directors utterly failed to implement any reporting or information system or controls” (prong one); or “having implemented such a system or controls, the directors consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention” (prong two).

While acknowledging that cybersecurity has increasingly become a central compliance risk warranting board level oversight for many companies, the court determined that the allegations did not meet the high bar required to state a *Caremark* claim. The court found that “plaintiff had not shown that the directors completely failed to undertake their oversight responsibilities, turned a blind eye to known compliance violations, or consciously failed to remediate cybersecurity failures.”

With respect to the first prong of *Caremark*, the court stated that the complaint itself showed that the board had systems in place to assess cybersecurity risks. As to *Caremark*’s second prong, the court stated that plaintiff did not plead with particularity that the post-acquisition board learned of legal or regulatory violations. The court went on to state that even if the board had, it did not consciously choose to remain idle. The court drew a distinction between pleading that directors failed to comply with non-binding industry standards and pleading that directors knowingly permitted the company to violate positive law. The court concluded that there was “no known illegal conduct, lawbreaking, or violations of a regulatory mandate alleged in the Complaint that could support a finding that the Post-Acquisition Board faces a substantial likelihood of liability for failed oversight.” The court also stated that the “red flags” at issue merely concerned Starwood’s inadequate data protection systems, and that plaintiff did not allege that Starwood’s standards ran afoul of regulatory or legal requirements.

Drawing a distinction between a flawed effort and a deliberate failure to act, the court stated that a *Caremark* violation requires a plaintiff to demonstrate the latter. The court concluded that the complaint lacked “particularized allegations demonstrating that the Post-Acquisition Board knew that the vulnerabilities in Starwood’s data system ran afoul of the law, that it nonetheless chose not to address them, or that it scorned legal notification requirements.”

4. *In re The Boeing Co. Derivative Litigation*

Background and Procedural History. Following two fatal crashes involving Boeing’s 737 MAX airplanes in 2018 and 2019, plaintiff stockholders brought derivative claims against the company’s directors alleging breach of fiduciary duties by: (i) failing to implement a reasonable information and reporting system to monitor and oversee airplane safety before the first crash; (ii) consciously disregarding their duty after the first crash to investigate and to remedy any misconduct uncovered; and (iii) providing false public safety assurances after the second crash. Defendants moved to dismiss pursuant to Court of Chancery Rule 23.1 for failure to plead demand futility.

Plaintiffs Pled That Demand Is Futile for Claims Against the Directors. The court held that plaintiffs pled demand futility against the directors. Plaintiffs had asserted that demand was futile because nine of the

12 directors when the original complaint was filed faced a substantial likelihood of liability for failure to fulfill their oversight duties under *Caremark*, as applied by *Marchand*.

The court stated that *Marchand* was dispositive due to similar factual allegations. In *Marchand*, the failure to manage the regulatory compliance risk of food safety at the board level allegedly allowed the company to distribute listeria-tainted ice cream. The *Marchand* Court noted that the board's oversight function must be more rigorously exercised in the face of risk pertaining to a company's "most central safety and legal compliance issue"—there, food safety. In *Boeing*, the court noted that plaintiff had sufficiently alleged that the board had no committee charged with direct responsibility to monitor airplane safety; it did not monitor, discuss or address airplane safety on a regular basis; and it had no regular process or protocols requiring management to apprise the board of airplane safety. As to *Caremark*'s second prong, plaintiff sufficiently alleged that Boeing management knew that the 737 MAX had numerous safety defects, but did not report these facts to the board. The court stated that this supported plaintiff's allegation that the board failed to establish a reporting system.

The Court Makes an Explicit Finding of Scienter. The court also determined that the pleading-stage record supported an explicit finding of scienter. The court stated that not only did the directors act inconsistently with their fiduciary duties, but the pleadings established that they also knew of their shortcomings. The court stated that no inference was needed to reach this conclusion in light of director emails confirming that the directors knew the board should have had structures in place to receive and consider safety information. The court further stated that the conclusion that the board knowingly fell short was also evident in its "public crowing about taking specific actions to monitor safety that it did not actually perform."

Key Takeaways

- The Court's decision in *Brookfield* means that stockholders can no longer sue controlling stockholders directly for diluting the value of their shares and voting rights. These claims must be brought as derivative claims under *Tooley* because the harm to individual stockholders flows from harm to the corporation, and any recovery to stockholders would flow from the company's recovery. The Court's decision may discourage prospective plaintiffs as derivative claims are more procedurally complex.

- The Court's decision in *UFCW Union* bolsters the standards for Delaware's demand-futility test by harmonizing the standards for assessing the need to make a demand. Perhaps anticipating that its decision may be viewed as a drastic change, the Court stated that "the three-part test is consistent with and enhances *Aronson*, *Rales*, and their progeny[.]" The Court continued that it "need not overrule *Aronson* to adopt this refined test, and cases properly construing *Aronson*, *Rales*, and their progeny remain good law."

- In line with most *Caremark* cases, plaintiff in *Sorenson* failed to meet the high bar required to state a claim. While in this case cybersecurity was not viewed akin to food or airplane safety as central to a hotel

company's business, it could be considered in the future as some company's "most central safety and legal compliance issue." Continued attention must be paid by boards to cybersecurity issues.

- As *Sorenson* shows, while it is rare for a plaintiff to succeed on a *Caremark* claim, the Delaware courts closely scrutinize a company's practices if that company is engaged in a business that presents a lethal risk. There has been a noticeable increase in *Caremark* claims surviving pleading challenges post-*Marchand* and this trend is likely to continue.

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