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The Demand on Directors in Derivative Actions and the Futility Regime

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0. INTRODUCTION

Starting from the late the nineteenth century, with companies starting to grow bigger and bigger and necessitating of resources exceeding by far the wealth of the single average family, the business community began to aggregate a plurality of small investments in a single enterprise, called corporation. The corporate form was so appealing especially due to a pair of seemingly trivial properties: investor ownership and transferability of shares. To guarantee that such an enterprise – owned by a multiplicity of individual investors contributing only a small fraction of the capital and who have the possibility, at any time, to withdraw their investment by freely transferring their shares – thrives and survives in an efficient manner (i.e. limiting costs), the one trait which has to be preserved is the separation of ownership from control. That is, shareholders and managers have to be distinct groups in order to minimize the costs of coordination (decision-making would be significantly impaired in the presence of hundreds, maybe thousands of investors) and of the potential change of identity of shareholders (each time a share is sold).

This is, simply put, where the delegation of authority to a board of directors comes from. But what about its flipside, accountability? The conflict of interests that arises in connection with surrendering control to actors (agents) different from the ultimate owners (principals), and the agency costs therein entailed, is what corporate law principally aims at policing through corporate governance mechanisms (e.g. fiduciary duties). Nevertheless, in the absence of an ultimate controller (i.e. the residual claimants – the shareholders, who, per definition, cannot interfere in the management), accountability is what kicks in in the event of a breach, by the directors, of the fiduciary duties they owe to the corporation (and, consequently, its shareholders). The possibility to be held personally liable for their actions is what (should) keep board members in check. But how does this abstract concept translate into the real world? Through the derivative action, namely the ability of the stockholders to sue, in the corporation's name, directors who exploited their discretion for purposes diverse from furthering the corporation's (thus, the stockholders') best interests (e.g. self-dealing). That is, board members who abuse their authority (which they had been granted by the shareholders in the first place) shall be held accountable for their misfeasance.

Balancing the values of authority and accountability one of corporate law's central questions. How do we give such a possibility to shareholders without risking that they, themselves, abuse their position? First of all, by setting procedural requirements which a prospective plaintiff has to comply with before giving him the scepter of the derivative suit. The most important one is, by far, the demand requirement. Partly for reasons of transparency, partly for reasons of informational advantage, a prospective plaintiff, prior to initiating a derivative action, shall make a demand upon the board of directors, asking them to either redress (without going to court) the harm suffered by the corporation, or – if they decide it being in the company's best interests – to bring the suit themselves.

Some U.S. jurisdictions, most notably Delaware and New York, achieve the same tradeoff between authority and accountability through a (slightly) different vehicle: the so-called futility of demand. This futility regime prescribes that there has to exist an exception to the demand requirement, in cases where directors are so interested/non-independent with regards to the transaction challenged by shareholders, that they cannot reasonably be trusted in making an impartial decision when evaluating a litigation demand. Would they really proceed with a legal action, if that meant being potentially found liable for a transaction they approved or from which they benefitted in the first place? In these situations, a plaintiff is allowed to directly bring their claims to court, since the outcome of such an evaluation would be a foregone conclusion.

Until very recently, there have been two main standards utilized by Delaware courts – arguably the leading authority when speaking of futility regime, and probably of corporate law in general – in the assessment of whether demand should be excused as futile: those set out in *Aronson v. Lewis* (1984) and *Rales v. Blasband* (1993). The fundamental distinction is that the former investigates the underlying transaction (the subject of the derivative action itself) to find out whether the directors who made that decision are either directly interested (i.e. they received a material personal benefit from the transaction not equally shared by stockholders), or non-independent (i.e. they lack independence from someone having received such a material personal benefit) or if the approval of the transaction otherwise amounts to a breach of fiduciary duty, such that, because of the risk of liability which would result from a legal action, they would have an evident bias in deciding whether to go forward with said action. Whenever the board having approved the transaction is different from the board which would receive the demand (e.g. due to resignations/replacements), the latter test applies, by directly questioning whether there exist disqualifying interests which would render board members impartial in evaluating a litigation demand (either due to some personal pecuniary advantage not equally shared by the stockholders or when a corporate decision would have a harmful impact on the director but not on the corporation).

Originally, the *Rales* test was intended to be a special application of the general *Aronson* test. Recently, both standards have been replaced by a new standard outlined in *United Food and Commercial Workers Union v. Zuckerberg* (2021), which recognizes *Rales* as being the broader standard encompassing *Aronson*, and not vice versa. The novel three-pronged test, having *Rales* as a starting point, inherits the focus on the core of the futility inquiry, namely the asking whether the board could impartially consider a demand, as opposed to *Aronson*'s focus on the underlying transaction. This so-called "improved *Rales*" seeks to discover either a material personal benefit of the director (not equally shared by stockholders), or a dependence from someone having received such a benefit, or – and here comes the "novelty" – a risk of facing liability (or dependence from someone facing such a risk), bequeathed by *Aronson* and representing a prelude of impartiality in deciding upon a litigation demand.

Although the new standard is, in the end, all but disruptive, *United Food* itself is a case which presents some interesting themes worth discussing. First, the reasons behind the need to revisit the futility standard in the first place, namely the evolution of the legal environment since *Aronson*'s adoption (e.g. the

introduction of exculpation statutes as a response to *Smith v. Van Gorkom*): duty of care claims no longer pose a threat that neutralizes director discretion. Second, the progressive diffusion of constituency statutes (an extraordinarily current topic; e.g. the Accountable Capitalism Act proposed by Sen. Elizabeth Warren in 2018), which would allow directors to make a decision which may be second-best for shareholders, but enhances the welfare of other stakeholders (e.g. employees or communities). Third, the prominence a controlling shareholder may have in influencing a board of purportedly independent directors, who might tend – out of psychological pressure or deference – to be biased in his favor ("structural bias"), albeit without receiving a material benefit and being technically labeled interested/non-independent, in a way that would trigger the intervention of the futility exception to the demand requirement. And finally, a criticism to the new test which, having lost *Aronson*'s second prong due to the aforementioned Section 102(b)(7) exculpation clauses, lacks the "safety net" which would capture exactly that structural bias, described above, which passed unnoticed in *United* Food, ultimately leading to the dismissal of the case.

The path this paper follows in describing the new demand futility standard set out in *United Food*, passes through a brief digression, in Part I, on the Derivative Suit and its importance as a device to achieve the proper balance of Authority and Accountability with the help of its Procedural Aspects and, specifically, the Demand Requirement. Such a balance gets further dissected in Part II, with an excursus on the evolution of the Demand Futility standards and their corresponding tests in Delaware, then compared to other jurisdictions (New York, Florida) and to universal demand states (i.e. those in which the futility exception is not an option). Part III is dedicated to *United Food and Commercial Workers Union v. Zuckerberg*, a case which, other than stating a new demand futility test and discussing the themes of director independence and risk of liability, reminds us that courts may sometimes decide to apply or not to apply a standard in a strict/literal manner, depending on the policy purposes they eventually want to achieve.

I. DERIVATIVE SUITS AND DEMAND

1.1. Accountability

One of the key assumptions business owners consent to when choosing the corporate form is that the authority to manage the company has to be delegated to someone who, at least in the basic concept, has no direct proprietary interest in it (i.e. someone different from the residual claimants). The conflict of interest this owner-manager agency problem conceives[1] (which is what Corporate Law principally aims at handling) is usually mitigated, other than giving shareholders some decision rights, by exploiting a system based on monitoring. Whenever this function falls short of expectations (i.e. whenever a manager fails to keep the owners' trust by breaching his/her fiduciary duties – owed to the corporation as an entity[2]), accountability is what comes into play, trying to re-align the respective roles of the actors. Accountability – though – is an abstract notion: and the means through which it gains a concrete form is the derivative lawsuit.[3]

Will the risk of being held accountable (i.e. liable) force directors to act in a manner which fully adheres to what shareholders would do, were they to make the same decision? Probably not. Neither will the adoption of strategies aimed to constrain agents or to align incentives.[4] Unless we let ownership and control coincide (e.g. like in an individual proprietorship), agency costs (i.e. cost of trying to contain shirking + residual loss: the cost of ultimately choosing a path which is different from the desired one) will always be present. An agent will inevitably find himself in a situation which will produce a suboptimal outcome, either as a result of behaving negligently, doing a mistake or putting interests other than the principals' first.[5]

So, why has the corporate form flourished in the last two centuries? By simply eliminating this separation between ownership and control, these costs would practically be set to zero. The rational answer to that is that there has to exist some sort of benefits (behind the discretion a board is entitled to) which outweigh these losses. This the question which underlies the greater part of Corporate Law, namely finding the best possible balance between the power to make decisions (i.e. authority) shareholders are willing to surrender, and the extent (i.e. accountability) to which directors are willing to be held responsible for their actions (up to a point where nobody would want to accept such a position).

Anyhow, a system of corporate governance which is based on accountability mechanisms as ultimate aid to the monitoring by principals, will likely have a maximizing effect on efficiency, by ensuring that agents act properly, because corporate officers under an obligation to account for what they do are typically

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[1] *See* ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 741 (R.H. Campbell, A.S. Skinner & W.B. Todd eds., Clarendon Press 1976) ("The directors of such joint stock companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own.").
[2] STEPHEN M. BAINBRIDGE, CORPORATE LAW 235 (4th ed. 2020).
[3] *See* ROBERT CLARK, CORPORATE LAW 639-40 (1986) ("One of the most interesting and ingenious of accountability mechanisms for large formal organizations.").
[4] See generally REINIER KRAAKMAN et al., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 31-32 (3d ed. 2017).
[5] *See* ADAM SMITH, *supra* note 1 ("Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honor, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.").

deemed to operate optimally.[6] This is – in general – what leads individuals to comply with what the authority commands: the fear of getting a speeding ticket will (usually) invite a rational automobile owner to drive slowly. As John C. Coffee Jr. (1993) wrote, speaking about judicial oversight of boards' dynamics, "The knowledge that one is being watched and that one must justify one's actions improves the behavior of most individuals."[7] Shareholders of a corporation effectively transfer their powers to the board, and what they require in exchange is the possibility to hold them accountable[8] and bring them back in line, if they misuse said power.[9] We are talking about the two sides of the same medal: an increase in authority will have to come at the cost of an increase in accountability. When this mechanism breaks down (i.e. one of the two values grows disproportionately), rational actors will face incentives either to refrain from serving as a director (Δauthority<Δaccountability), or to put their own interests first (i.e. self-dealing) and acting in bad faith (Δauthority>Δaccountability). And that's when private enforcement (i.e. initiated by private parties, shareholders in our case) has to come into play, and re-align managers' incentives to shareholders' interests.

1.2. <u>The Derivative Suit</u>

In a derivative suit (as opposed to a direct suit[10]), shareholders are nothing more than representatives of the corporation. The corporation incurs the harm, the cause of action belongs to the corporation, and so does any recovery (both monetary and non-monetary) which originates from said claim. What is, then, the role of the shareholder-plaintiffs? How is it possible that, contrary to the aforementioned principle of deference to the board's decision-making authority, principals are given the possibility to interfere with the agents' conduct? Directors are typically said to owe fiduciary duties to their corporate entity.[11] So, in case of a wrong suffered by the firm, one could reasonably expect that directors themselves (being, by the way, the ones ordinarily entitled to make such a decision[12]) would be the first to defend its rights, which is usually the case, since derivative actions are just an exception to the rule.[13] Shareholders are allowed to redress an injury caused to the company just in situations where the likelihood that managers will address the issue themselves is presumably low (i.e. when the company is represented by the very perpetrators of such an

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[6] *See* Andrew Keay & Joan Loughrey, *The Framework for Board Accountability in Corporate Governance*, 35 LEGAL STUDIES 252, 261 (2015).
[7] John C. Coffee, Jr., *New Myths and Old Realities: The American Law Institute Faces the Derivative Action*, 48 BUS. LAW. 1407, 1425 (1993).
[8] *See* Andrew Keay & Joan Loughrey, *supra* note 6, at 263.
[9] *E.g.* STEPHEN M. BAINBRIDGE, *supra* note 2, at 236 ("Specific suits that have been characterized as derivative in nature include claims involving corporate rights arising out of tort or contract, monetary damages based on corporate mismanagement, executive compensation, waste of corporate assets, and the adequacy of consideration for issuance of corporate stock."); *see also* Daniel J. Dykstra, *The Revival of the Derivative Suit*, 116 U. PA. L. REV. 74, 77-78 (1967).
[10] Seth Aronson et al., *Shareholder Derivative Actions: From Cradle to Grave,* O'MELVENY & MYERS LLP 2, ¶ 1(d) (June 2009), *available at* https://www.mondaq.com/pdf/clients/87654.pdf/ ("[A]n action brought by a shareholder for harm done to an individual shareholder or a group of shareholders is a direct action.").
[11] *See* STEPHEN M. BAINBRIDGE, *supra* note 2 and accompanying text.
[12] 8 DEL. C. § 141(a), *available at* https://delcode.delaware.gov/title8/c001/index.html ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . .").
[13] 8 DEL. C. § 122(2), *available at* https://delcode.delaware.gov/title8/c001/index.html ("Every corporation created under this chapter shall have power to sue and be sued . . . .").

harm).[14] In the presence of such a conflict of interests, the only way to ensure that wrongdoings enacted by insiders (or, in some cases, by outsiders) of the company will not remain unnoticed is to bend the rules and concede to shareholders (i.e. the party who has a real/direct interest in making sure that the company operates correctly) the right to initiate such a particular kind of legal action, which is nonetheless subject to delicate prerequisites[15] with the scope of limiting its use to cases of real necessity (i.e. to avoid abuses of said exception), ultimately safeguarding directors' primacy in managing the affairs of the corporation.

Trying to distinguish whether a claim would have to be enforced through a direct or a derivative suit is probably far from simple, considering the wide discretion courts have demonstrated in deciding cases in the past,[16] and that the same set of facts might potentially give rise to direct, derivative, or even combined direct and derivative claims.[17] First, it was the American Law Institute Principles of Corporate Governance[18] which tried to concretely define a dividing line between said claims (other than by providing a non-exhaustive list[19] of actions likely to be characterized as direct) by asking the following two questions when confronting an unclear case:

- Who suffered the most immediate and direct injury?
- To whom did the defendants' duty run?

As we can see, the focus of this analysis lies on recognizing the injured party (and whether he was owed any fiduciary duties).

This approach was consistently adopted by the Delaware Supreme Court,[20] yet adding a focus (i.e. test) on the nature of the relief being sought. What Charles L. Grimes[21] was asking for, in fact, was just the annulment of an employment contract (i.e. injunctive relief, non-monetary), thus signaling that courts may prefer to consider a suit as derivative just when monetary relieves are at stake.

Another pivotal point in the evolution of the distinction between direct and derivative actions is the seminal *Tooley*[22] opinion, where the Delaware Supreme Court, acknowledging that numerous prior decisions

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[14] Lewis v. Knutson, 699 F.2d 230, 237-38 (5th Cir. 1983) ("When an officer, director, or controlling shareholder breaches a fiduciary duty to the corporation, the shareholder has no standing to bring civil action at law against faithless directors and managers, because the corporation and not the shareholder suffers the injury; equity, however, allows him to step into the corporation's shoes and to seek in its right the restitution he could not demand on his own.").
[15] *See infra* Chap. *1.3*. Procedural Aspects of Derivative Suits.
[16] *See* Seth Aronson et al., *supra* note 10, at 3-9, ¶¶ (2)(a) to (2)(f) ("It is not always easy to tell whether an action is derivative or direct . . . Courts have wide discretion to determine whether an action is derivative or direct . . . Deciding whether an action is direct or derivative has been greatly complicated by courts . . . .").
[17] Id.; *see also* Gentile v. Rosette, 906 A.2d 91, 99-100 (Del. 2006) (determining that a claim may be both direct and derivative if "(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."); *but see* William Savitt & Ryan A. McLeod, *Delaware Supreme Court Eliminates "Dual-Natured" Direct and Derivative Claim*, HARV. L. SCH. F. ON CORP. GOV. (Sep.23, 2021), *available at* https://corpgov.law.harvard.edu/2021/09/23/delaware-supreme-court-eliminates-dual-natured-direct-and-derivative-claim/.
[18] ALI PRINCIPLES OF CORPORATE GOVERNANCE § 7.01.
[19] *Id.* § 7.01 cmt. c (for example, actions to enforce a right to vote, to prevent the improper dilution of voting rights, to enjoin the improper voting of shares, to compel or protect dividends, to prevent the oppression of, or fraud against, minority shareholders, or to require the holding of shareholders' meetings).
[20] Grimes v. Donald, 673 A.2d 1207 (Del. 1996).
[21] *Id*.
[22] Tooley v. Donaldson, Lufkin & Jenrette Inc., 845 A.2d 1031 (Del. 2004).

involved the so-called special injury test,[23] replaced it (finally, after many uncertainties) with a definite two-pronged standard which will completely substitute every other test used so far,[24] and whose importance will be restated in numerous subsequent rulings, until quite recently.[25] The focus, under said test, is on showing whether the stockholder has suffered an injury that is not dependent on an injury to the corporation, by asking the following two questions[26]:

- Who suffered the alleged harm (the corporation or the suing stockholder, individually)?
- Who would receive the benefit of any recovery or other remedy (the corporation or the suing stockholder, individually)?

In general, as with most of Corporate Law's issues in the United States (i.e. as a country following the common/case law approach), every case has had and will have different premises, different environments and different judges, thus every different application of the same standard could potentially produce a different outcome. Like, for example, in the recent *Brookfield* opinion,[27] where the Delaware Supreme Court explicitly committed itself to consistency (specifically, to the *Tooley*-standard), in particular considering cases (like *Brookfield*), when a merger removes a stockholder's standing to pursue derivative claims,[28] thus contributing to befog an already unclear matter.

A recent example of a case encompassing both the definition of a direct and a derivative action is United Food v. Zuckerberg.[29] Shareholders sued directly (the 13 different direct suits were then regrouped as a class action) when challenging the approval of a reclassification which would have negatively affected their interests in the company in a direct manner, by diluting their ownership stake. The decision to moot the class action, though, was later challenged in a derivative action: in fact, by deciding to settle the claim (without going on with the original plan) and to pay the plaintiff's attorneys' fees, the board implicitly recognized that the underlying transaction (i.e. the reclassification) wasn't in the best interests of the corporation. Thus, the board members purportedly would have had to return the amount the corporation had to pay for a damage they caused (via a breach of fiduciary duty), but which was ultimately borne by the firm itself (and its shareholders).

1.3. Procedural Aspects of Derivative Suits

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[23] *Id.* at 1038 ("A special injury is a wrong that is separate and distinct from that suffered by other shareholders, . . . or a wrong involving a contractual right of a shareholder, such as the right to vote, or to assert majority control, which exists independently of any right of the corporation."); s*ee also* Seth Aronson et al., *supra* note 10, at 5-6, ¶ (2)(c) (requiring "[s]hareholders to show that they have suffered a special or distinct injury from other shareholders . . . .").
[24] *See* Tooley *supra* note 22, at 1033 ("The analysis must be based solely on the following questions . . . ."); *see also* Seth Aronson et al., *supra* note 10, at 6-7.
[25] *See* Andrew W. Stern, *Direct vs. Derivative Standing*, HARV. L. SCH. F. ON CORP. GOV. (Oct. 26, 2021), *available at* https://corpgov.law.harvard.edu/2021/10/26/direct-vs-derivative-standing/; *see also infra* note 27.
[26] *E.g.* STEPHEN M. BAINBRIDGE, *supra* note 2, at 237; *see also* Seth Aronson et al., *supra* note 10, at 6-7.
[27] Brookfield Asset Management, Inc. v. Rosson, 2021 WL 4260639 (Del. Sep. 20, 2021).
[28] *See* Brian M. Rostocki et al., *Delaware Supreme Court Strikes Down Dual-Natured Direct/Derivative Claims in Stockholder Dilution Claims*, REED SMITH LLP (Oct. 8, 2021), https://www.lexology.com/library/detail.aspx?g=74d97fda-4619-4e85-848c-1c5bf4fada2c/.
[29] *See* United Food, *infra* note 149 and accompanying text.

Per definition, shareholder-plaintiffs usually (but not always, as in *Perlman*[30]) aren't entitled to any of the amounts eventually recovered in a derivative settlement, which of course would flow directly to the corporate treasury. The only benefit they receive, (even) after successfully prosecuting a derivative claim, is a purported[31] increase in share price and an improved management (due to deterrence effect). It is well documented[32] that, after all, the real party having an interest in pursuing derivative claims (including those having limited support by evidence and/or other shareholders – the so called strike/frivolous/nuisance suits[33]) is the plaintiff's legal counsel. Although the trend has long been that of liberalizing[34] derivative suits (i.e. encouraging them, from 1944[35] up to the 1970s – supported by a spike in their numbers and frequency), probably because of the recognition of its essential role as a corporate governance policing mechanism,[36] recent years have seen regulators go in the exact opposite direction, namely that of restricting the adoption of said enforcement instrument through costly/time-consuming procedural requirements. Their objective is that of making it unfavorable[37] to pursue a derivative claim, unless there is a concrete prospect of conveying some benefit to the corporation (i.e. the suit is not a strike suit), that is limiting the abuse of strike suits, which usually just take up time and resources companies should concentrate on conducting their business.

Some of these prerequisites – like the verification and the fair and adequate representation requirements – have today evolved into seemingly trivial formalities, being on one side scarcely enforced and on the other, easily avoidable.[38] The former[39] requires plaintiffs (and/or their counsel) to put into writing that they have informed themselves about the claim, and that they found it to be significant. The latter[40] aims at making sure that the plaintiff receives adequate support by fellow shareholders in order to make sure that he doesn't bring action just for personal motives. Over time courts have demonstrated, however, that both

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30 Perlman v. Feldmann, 219 F.2d 173 (2d Cir. 1955) (Plaintiffs were awarded a share of the premium paid by the third party for the controlling interest.).
31 *See, e.g.*, Thomas P. Kinney, *Stockholder Derivative Suits: Demand and Futility Where the Board Fails to Stop Wrongdoers*, 78 MARQ. L. REV. 172, 174 (1994) ("A common concern is how much justice is really received from a derivative suit: the stock price usually shows only marginal improvement . . . .").
32 *See, e.g.*, John C. Coffee, Jr., *infra* note 33 ("[A]ttorneys' incentives are the key factor in shareholder litigation."); *see also* Donald A. Wittman, *Is the Selection of Cases for Trial Biased?*, 14 J. LEGAL STUD. 185 (1985) ("[T]he attorney is the relevant decisionmaker and has little interest in effecting cost savings by avoiding a trial."); *see also* Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 61 (1991) ("[A]wards are paid to attorneys far more frequently than to shareholders . . . ."); *Id.* at 63 ("A likely explanation . . . is the need to paper a record to justify an award of attorneys' fees to courts.").
33 *See* John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, 48 LAW & CONTEMP. PROBS. 5, 13 (1985) ("The Standard Theory of the strike suit was succinctly stated by Justice Black when he characterized the strike suit as one brought by people who might be interested in getting quick dollars by making charges without regard to their truth so as to coerce corporate managers to settle worthless claims in order to get rid of them.").
34 *See* Daniel J. Dykstra, *supra* note 9, at 77 ("[I]t is surprising that the number of derivative suits is increasing . . . there is a growing judicial and legislative awareness of this role, an awareness which has permitted increased flexibility in the technical structure of the derivative suit.").
35 *But see infra* notes 49 & 51 and accompanying text (an exception is New York's adoption of security-for-expenses statutes).
36 *Id.* at 78 ("It is because the derivative suit is a needed policeman that it has refused to die.").
37 *Id.* at 75 ("[B]y-products of the strike suit and represent reactions to abuse of the judicial process by stockholders whose motive in bringing suit is personal gain rather than corporate benefit.").
38 *See, e.g.*, STEPHEN M. BAINBRIDGE, *supra* note 2, at 246 ("Given the verification requirement's substantial erosion, it now seems wholly pointless."); *see also* Daniel J. Dykstra, *supra* note 9, at 75 ("[L]itigants currently walking the derivative road will occasionally find that they can plow through or avoid hurdles which were previously insurmountable.").
39 FED. R. CIV. P. 23.1 ("The complaint shall be verified . . . ."); ALI PRINCIPLES OF CORPORATE GOVERNANCE § 7.04(b).
40 FED. R. CIV. P. 23.1 ("The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of shareholders . . . ."); MODEL BUSINESS CORPORATION ACT § 7.41(2).

principles serve the purpose of discouraging nuisance suits, and not derivative suits in general. That means that even in the presence of clear evidence supporting claims of fraudulent behaviors, non-compliance[41] with said requisites is not automatically grounds for dismissal.

The need for judicial scrutiny and approval[42] of derivative settlements is, similarly, deemed to be an obstacle which is not difficult to circumvent ("not a significant barrier"[43], in John C. Coffee's words). Ideally aiming at discouraging collusive agreements, judges rarely oppose proposals to settle the case, either because of deference to the independent directors' decision, or because of identifying the "substantial benefit" (necessary to award attorneys' fees) in the cost savings of resolving the litigation.[44]

One aspect on which jurisdictions across the United States pretty much agree is that to initiate (and maintain) a derivative suit, a plaintiff has to be a shareholder not only at the time of the filing, but he must have owned his shares even at the time the alleged wrong occurred. This so-called contemporaneous ownership rule[45] (which – by the way – was already in place in 1881[46]) eliminates the possibility that a plaintiff will acquire shares in a company in the meantime for the sole purpose of extracting some kind of profit in court. An exception is the continuing wrong doctrine[47]: there are some misbehaviors whose (negative) consequences may be evident for a long time after their occurrence, and it would be unjust to protect the perpetrators of such misbehaviors by dismissing a claim for lack of standing. Some jurisdictions[48] extend the contemporaneous ownership requirement in that the disposal of shares by a plaintiff before a trial ends (i.e. before judgment is delivered), may be grounds for dismissal.

No jurisdiction explicitly sets a minimum threshold of stock ownership for plaintiffs to satisfy the aforementioned rule. Some of them – though – allow for security-for-expenses statutes, which set certain conditions for the owners of less than a specific amount of stock. These are relatively long-lived (they have

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[41] E.g. Surowitz v. Hilton Hotels Corporation, 383 U.S. 363 (1966) (When questioned, plaintiff couldn't demonstrate her knowledge of the facts alleged, which was found to be due to her limited understanding of economic matters, and of the English language in general. She had been advised by her son-in-law, about facts which would then be proved as accurate. Justice Black refused to strictly comply with Rule 23.1, since it would be unjust to dismiss the prosecution of a plainly fraudulent act, and permitted the case to proceed nonetheless.).

[42] FED. R. CIV. P. 23.1 ("A derivative action may be settled . . . only with the court's approval. Notice of a proposed settlement . . . must be given to shareholders . . . ."); MODEL BUSINESS CORPORATION ACT § 7.45.

[43] *See* John C. Coffee, Jr., *supra* note 33, at 26 ("[I]deally a sensible judge will not approve a settlement in which the fees appear disproportionate to the benefit obtained, it sadly does not follow that the judicial approval requirement is a significant barrier to collusive settlements.").

[44] *Id.* at 27 ("[S]ubstantial benefit . . . can be found in the fact that costly burdensome litigation is being resolved that would otherwise drain the corporation's treasury.").

[45] *E.g.* FED. R. CIV. P. 23.1; N.Y. BUS. CORP. L. § 626(b); 8 DEL. C. § 327, *available at* https://delcode.delaware.gov/title8/c001/index.html.

[46] *See* Hawes v. City of Oakland, *infra* note 53 ("[I]t must also be made to appear that … the ownership of the stock was vested in him at the time of the transactions of which he complains . . . .").

[47] *See, e.g.*, Kyle Graham, *The Continuing Violations Doctrine*, 43 GONZ. L. REV. 271, 272-73 (2008) ("[C]ontinuing misconduct by a defendant will justify the aggregation or parsing of its misbehavior, with the effect of rescuing a plaintiff's claim or claims from the statute of limitations."); *see also* Seth Aronson et al., *supra* note 10, at 12 ("Under the continuing wrong doctrine, the contemporaneous ownership requirement will not apply . . . even if [the alleged wrong] began before the shareholder purchased the stock.").

[48] *Id.* at 17, ¶ (3)(a)(i) ("California law, like Delaware law, generally requires a plaintiff . . . to maintain continuous stock ownership throughout the pendency of the litigation. [A] derivative plaintiff who ceases to be a stockholder by reason of a merger ordinarily loses standing [unless] the merger itself is used to wrongfully deprive the plaintiff of standing . . . .").

been introduced in New York for the first time after Franklin S. Wood's report[49] in 1944 – finding that most derivative suits were brought by stockholders having no financial interest in prosecuting the suit), albeit not so diffused in U.S. jurisdictions[50] (interestingly, neither Delaware Code nor Federal Law include such a provision). They prescribe that prospective plaintiffs owning less than a certain threshold of shares[51] shall post a guarantee for the reasonable expenses the corporation may incur in connection with such action, when so requested by the defendant. The theory behind it is that litigation is costly, and that a rational actor will want to carefully consider whether his claims have a significant (hence, the fact that said prescription is directed at shareholders having negligible interests in the company) prospect of conveying benefits to the corporation which outweigh these costs, especially if he has to cover them himself in case of a negative outcome.

1.4. The Demand Requirement

The demand requirement (and especially the doctrine of demand futility that comes with it) is certainly one of the most complex (and debated) aspects of derivative litigation. One thing is certain: asking a prospective plaintiff to first give an opportunity to the corporation itself to pursue the purported claims (by making a formal demand on the board of directors) is not only theoretically prescribed (directors are by definition in charge of such a decision, having – among other things – an informational advantage over shareholders), but is also adopted in basically every U.S. jurisdiction,[52] since more than a century.[53] What are the doctrinal explanations of such a far-reaching principle? First of all, directors (not shareholders) are statutorily entitled to make major corporate decisions.[54] As such, it is correct to inform them of the potential cause of action so that they, in the first instance, can discharge their duty of authorizing it (if they find it to be in the best interests of the corporation). Another reason is that directors, due to their informational advantage[55] (when compared to stockholders), are in the best position to evaluate whether a claim is justified, and if it is potentially addressable without having to resort to court trials (internal resolutions mean saving costs). In the case the claim has to be pursued, board members – again, given their privileged position

[49] FRANKLIN S. WOOD, SURVEY AND REPORT REGARDING STOCKHOLDERS' DERIVATIVE SUITS 27-29 (1944) ("[R]epresentative plaintiffs had very small stakes in the outcome.").
[50] *See* Seth Aronson et al., *supra* note 10, at 12 ("States that have adopted security-for-expenses statutes include Arizona, California, Colorado, Florida, Nebraska, New Jersey, New York, Pennsylvania, Wisconsin.").
[51] N.Y. GEN. CORP. L. § 61-b (originally); then N.Y. BUS. CORP. L. § 627 ("Security for expenses in shareholders' derivative action . . . unless the plaintiff or plaintiffs hold five percent or more of any class of the outstanding shares . . . and beneficial interest of such plaintiff or plaintiffs have a fair value in excess of fifty thousand dollars . . . .").
[52] *E.g.* FEDERAL EQUITY RULE 94, *replaced by* FED. R. CIV. P. 23(b), then FED. R. CIV. P. 23.1 (1966); MODEL BUSINESS CORPORATION ACT § 7.42; ALI PRINCIPLES OF CORPORATE GOVERNANCE § 7.02 cmt. e; DEL. R. CH. CT. 23.1; N.Y. BUS. CORP. L. § 626(c) ("[T]he complaint shall set forth with particularity the efforts of the plaintiff to secure the initiation of such action by the board or the reason for not making such effort.").
[53] Hawes v. City of Oakland, 104 U.S. 450 (1881) ("[I]t must also be made to appear that the complainant made an earnest effort to obtain redress at the hands of the directors and shareholders of the corporation . . . .").
[54] *See supra* note 12 and accompanying text; *see also* Thomas P. Kinney, *supra* note 31, at 173 ([S]hareholder can only commence the derivative suit if management refuses the demand.").
[55] Daniel R. Fischel, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. CHI. L. REV. 168, 171 (1976) ("Shareholders usually have little knowledge of the facts involved and lack access to the books and records of the corporation.").

– are able to establish the adequate amount of an eventual settlement (shareholder-plaintiffs might easily settle for an inadequate amount[56]: they both lack the appropriate incentives and the knowledge to do otherwise). And why do shareholders lack appropriate incentives? Because it's the board of directors, and not them, who owes fiduciary duties to the corporation. Meaning that just the latter is presumed to evaluate (and eventually pursue and settle) the alleged claim in good faith and in an informed manner – otherwise known as the business judgment rule.[57] Finally, transparency cannot but benefit from the demand requirement: why should a plaintiff proceed directly to court if the claim is driven by the honest belief that it is in the best interests of the corporation?

Nevertheless, some U.S. jurisdictions (in reality, most of them[58]) do allow for an exception to the precondition that prospective plaintiffs make a demand upon the board of directors – the so-called futility regime, a feature which has evolved into (probably) the central and most controversial question of derivative actions.

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[56] ALI PRINCIPLES OF CORPORATE GOVERNANCE § 7.03 cmt. a ("[I]t must be recognized that the corporation may have reason to fear an inadequate settlement that would preclude it from seeking further relief.").

[57] Aronson v. Lewis, 473 A.2d 805, 812 (del. 1984) ("It is a presumption . . . that directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.").

[58] *See* Seth Aronson et al., *supra* note 10, at 24 (noting that following jurisdictions require demand in all circumstances without exception for futility: Arizona, Connecticut, Florida, Georgia, Hawaii, Idaho, Massachusetts, Michigan, Mississippi, Missouri, Montana, Nebraska, New Hampshire, North Carolina, Texas, Virginia, Wisconsin); more recently, Pennsylvania joined this list by signing into law PA. ACT 170 (Nov. 2016).

II. DEMAND FUTILITY

2.1. Evolution of Standards and Tests

In order to get access to the court, a stockholder must either see his demand ignored or refused[59] by the board (i.e. challenging the propriety of the decision), or otherwise describe, with particularity,[60] why making a similar demand would have been superfluous (i.e. invoking the demand futility exception). In general the focus of such an inquiry has been, along the years, on finding out whether directors were under some sort of influence (diverse from their fiduciary duties – care, loyalty and good faith) which tainted their impartiality, and thus their ability to conduct a neutral investigation (and eventually pursuing) a claim.[61] Delaware (specifically the Delaware Supreme Court) – arguably the lead jurisdiction when talking about the futility regime – already in 1927 deemed demand unnecessary where directors were considered unable to manage litigation "by reason of hostile interest, or guilty participation in the wrongs complained of."[62] Similarly, in 1931 the Court of Chancery affirmed that demand would be futile where directors were "under an influence that sterilizes [their] discretion and could not be proper persons to conduct the litigation."[63]

Finding directors' interest, thus, has been the historical factor on which, on one side, plaintiffs hinged their allegations that making a demand upon such a board would have been futile (i.e. its refusal would have been a foregone conclusion), and on the other, which courts' stressed in the analysis of said cases.[64]

The first attempts to transform such an abstract principle into a practical rule (in the form of a test) coincided with the inclusion of the business judgment doctrine into the question of demand futility. Before *Zapata*,[65] in fact, courts had, in the absence of involvement in the alleged wrongdoings or plain evidence indicating some sort of undue interest, an almost unquestioned deference to the board's discretion in evaluating a plaintiff's demand (i.e. whether to accept, ignore or refuse it). With it, the Delaware Supreme Court afforded courts a far more intrusive role: with a two-stepped approach,[66] they are now to inquire not only whether the board (in the specific case, the independent committee) is really independent, duly informed and acting in good faith (which would already, standing alone, contradict the business judgment rule's basic presumption[67]), but also whether, in the specific case, the motion to dismiss the case is appropriate (i.e. in the company's best interests), effectively substituting the court's own business judgment

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[59] *See supra* note 54 and accompanying text.
[60] *See supra* note 52; *see also* Daniel R. Fischel, *supra* note 55, at 179 ("[I]f mere allegations . . . were sufficient to excuse demand, the requirement would be continuously circumvented.").
[61] Elizabeth A. Wilburn, *Beyond Aronson: Recent Delaware Cases on Demand Futility*, 20 DEL. J. CORP. L. 535, 538 (1995) ("[W]hether directors possessed some disqualifying interest in the transaction yielding them incapable of making an objective business decision.").
[62] Sohland v. Baker, 141 A. 277, 281 (Del. 1927).
[63] McKee v. Standard Minerals Corporation, 156 A. 193 (Del. Ch. 1931).
[64] *See* Elizabeth A. Wilburn, *supra* note 61 ("These cases manifest the courts' historical preoccupation with the interest component of the demand futility analysis, as opposed to the actual business judgment underlying the transaction.").
[65] Zapata Corporation v. Maldonado, 430 A.2d 779 (Del. 1981).
[66] *Id*. at 788-89 ("First, the court should inquire into the independence and good faith of the committee and the bases supporting its conclusions . . . second, the court should determine, applying its own independent business judgment, whether the motion should be granted.").
[67] *See* Aronson v. Lewis, *supra* note 57.

to the committee's. This is what Dennis J. Block and H. Adam Prussin[68] have defined as an "offensive" (to be compared to a traditional "defensive" use[69]) use of the business judgment rule.

The link which joins previous approaches (*Sohland*/*McKee* and their quasi-total deference to the board's business judgment; *Zapata* and its intrusive standard) with the always actual (albeit not recent) *Aronson* test, is *Haber v. Bell*.[70] Said decision takes a step back from *Zapata* towards a more director-oriented stance: by presuming that, if a transaction has a valid business purpose,[71] the board is impartial, the Delaware Chancery Court placed a heavy burden on plaintiffs, who now – to overcome such a presumption – first have to plead facts sufficient to lift the protection granted by the business judgment rule.[72]

A further step in the same direction will be that made by the Supreme Court of Delaware in deciding *Aronson*. Its two-pronged test[73] further raised the bar by requiring plaintiffs to "create a reasonable doubt"[74] (as opposed to the "reasonable inference" appearing in *Haber*[75]) about either the disinterestedness and the independence of board members, <u>or</u> that "the challenged transaction was otherwise the product of a valid exercise of business judgment"[76] (just in a second moment, in *Levine*,[77] the court underlined that even satisfying one of the two prongs would suffice in making demand futile). The word "reasonable" has been the subject of much criticism and many doubts, due to its coincidence with criminal law's standard of "beyond any reasonable doubt" (likelihood of at least 90% of being found guilty). In *Grimes*,[78] the Delaware Supreme Court helpfully described the "reasonable doubt" necessary to prove demand futility as the one stemming from either a material interest, a lack of independence from someone having a material interest, or the absence of the protection granted by the business judgment rule ("the underlying transaction is not the product of a valid exercise of business judgment"[79]).

An approach which is more deferential to the business judgment rule than in *Zapata* is probably right, since it would be incorrect to place the burden of proof on the corporation (directly conflicting with the business judgment rule's presumption of independence, good faith and reasonableness[80] <u>and</u> corporate

[68] Dennis J. Block & H. Adam Prussin, *The Business Judgment Rule and Shareholder Derivative Actions: Viva Zapata?*, 37 BUS. LAW. 27, 38 (1981).
[69] *See* Sohland v. Baker, *supra* note 62, at 282 ("[B]ecause the law leaves business judgments in directors' hands, shareholders and courts should not lightly question directors' decisions.").
[70] Haber v. Bell, 465 A.2d 353 (Del. Ch. 1983).
[71] *Id.* at 359 ("The purpose of the transaction is questionable if no person of reasonable judgment would agree that the corporation received adequate consideration for the payments made to its officers and directors.").
[72] Michele M. Schaeffer, *Shareholder Seeking to Excuse Demand As Futile Must Overcome the Protection of the Business Judgment Rule:* Aronson v. Lewis, 473 A.2d 805 (Del. 1984), 63 WASH. U. L. Q. 167, 171 (1985) ("[T]he shareholder must plead facts sufficient to permit a reasonable inference that the directors' actions were unprotected by the business judgment rule.").
[73] *See* Aronson, *supra* note 57, at 814 ("[T]he Court of Chancery in the proper exercise of its discretion must decide whether, under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.").
[74] *See, e.g.*, Michele M. Schaeffer, *supra note* 72, at 171 ("[A] reasonable doubt is proof that allows no other conclusion.").
[75] *See* Haber v. Bell, *supra* note 70 and accompanying text; *see also* Michele M. Schaeffer, *supra note* 72; *Id.* at 171 (defining an inference as "a process of reasoning by which a fact sought to be established is deduced as a logical consequence from other facts already proven or admitted.").
[76] *See supra* note 73.
[77] Levine v. Smith, 591 A.2d 194, 205 (Del. 1991).
[78] Grimes v. Donald, *supra* note 20.
[79] *Id.*
[80] Smith v. Van Gorkom, 488 A.2d 858, 872 (1985) ("Unless this presumption is rebutted, the business judgment rule, as a substantive rule of law, attaches to protect the directors and the decisions which they have made.").

law's principle of delegated management[81]). But still, the structural bias[82] which may push even independent directors (and, consequently, even special committees) into the realm of impartiality (directors may be tempted to act in the interests of each other even if they're not directly interested/named as defendants, since they tend to identify with fellow directors who are possibly facing e.g. the risk of being held personally liable), may require a standard of review which is a little more intrusive than the traditional business judgment rule's abstention theory.[83]

The protection granted by the business judgment rule (which has to be deleted in order to plead demand futility) only applies to cases in which the board actually makes a decision.[84] Consequently, *Aronson* involves this limitation as well. And that's where the *Rales*[85] test comes to the aid of courts: by concentrating on the independence of the board members, it removes the necessity to include an analysis of a decision which never took place (or, as in the specific case, was made by the board of a subsidiary[86]). What are the specific situations to which said test is applicable (i.e. where the board considering the demand is different from the board having made the challenged decision)?

- "Where a business decision was made by the board of a company, but a majority of the directors making the decision have been replaced."[87]
- "Where the subject of the derivative suit is not a business decision of the board."[88]
- "Where the decision being challenged was made by the board of a different corporation."[89]

The question about the presence of disqualifying interests (either due to "some personal pecuniary advantage not equally shared by the stockholders"[90] or "when a corporate decision would have a harmful impact on the director but not on the corporation"[91]) has to be asked singularly with regards to each individual member of the board, and a positive answer has to come from a majority of board members, in order for the demand to be excused as futile (an individual interested/non-independent director does not suffice).

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[81] *See, e.g.*, 8 DEL. C. § 141(a), *available at* https://delcode.delaware.gov/title8/c001/index.html ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . .").
[82] *See* Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U. L. Q. 821, 824 (2004) ("[T]he result of the common cultural bond and natural empathy and collegiality shared by most directors, the economic or psychological dependency upon or ties to the corporation's executives, particularly its chief executive, and the process of director selection and socialization, which incumbent management dominates.").
[83] *See generally* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 84 (2004); *see also* Shlensky v. Wrigley, 237 N.E.2d 776, 778 (1968) ("[C]ourts will not step in and interfere with honest business judgment of the directors unless there is a showing of fraud, illegality or conflict of interest.").
[84] *See, e.g.*, Aronson v. Lewis, *supra* note 57 at 813 ("[T]he business judgment rule operates only in the context of director action.").
[85] Rales v. Blasband, 634 A.2d 927, 930 (Del. 1993) ("The court must ask whether the board that would be addressing the demand can impartially consider its merits without being influenced by improper considerations. The burden on the plaintiff is to establish that a reasonable doubt existed . . . that the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand. If the derivative plaintiff satisfies this burden, then demand will be excused as futile.").
[86] *See* Elizabeth A. Wilburn, *supra* note 61, at 548-49 ("Easco entered into a merger agreement with Danaher, which resulted in Easco becoming a wholly-owned subsidiary of Danaher. The plaintiff's complaint . . . asserted breaches of fiduciary duties by the Easco board in conjunction with an alleged misuse of corporate funds . . . Danaher directors never made a decision relating to the challenged transaction, rather the Easco board made the decision.").
[87] Rales v. Blasband, *supra* note 85, at 933.
[88] *Id*.
[89] *Id*.
[90] *Id*. at 936.
[91] *Id*.

In a recent case,[92] the Delaware Chancery Court specified another situation in which the appropriate test to establish demand futility is *Rales* (instead of *Aronson*), namely where the decision being challenged was taken by a committee (i.e. a subgroup composed of less than half of the board members). In fact, the court in *Baiera*[93] found that said test was appropriate because on one side the questioned agreement had been approved by the three-member audit committee, and on the other the demand (which hadn't been made by plaintiff) would have been scrutinized by a nine-member board, technically a distinct group.[94]

Other than the diverse situations in which to apply them, are there further significant differences between the two seminal (and, until recently with United Food,[95] untouched) futility standards? Yes. Actually, the very substance the tests intend to uncover is divergent.[96] By inquiring into the propriety of the board's decision regarding the underlying transaction (second prong and business judgment rule's protection), the *Aronson* test arrives only indirectly at discovering whether the board could impartially assess a demand, had it been made. The *Rales* test (and its heir *United Food*), conversely, asks said question in a direct manner, thus retaining its focus on the demand-stage, namely the ability of the directors to act independently and disinterestedly upon deciding whether the pursuit of the plaintiff's claims is in the best interests of the corporation, or not.

2.2. <u>Differences Among Jurisdictions (N.Y. – Florida)</u>

The different approaches to the futility regime may be placed on a continuum, having on one side the universal demand requirement[97] (set forth by MBCA and ALI Principles), which guarantees that every board will have received a demand before a derivative suit is brought, and on the other, the leading Delaware approach, basically implying that no rational shareholder will make a demand if he wants to retain some probabilities that the case won't be dismissed at the pre-trial stage, since making a demand in Delaware means conceding that the board is independent, which in turn means that there is no reason to trump its authority.[98]

Between these extremes, albeit very close to Delaware's, lies the New York approach. Its standard – set out in *Marx v. Akers*[99] – substantially tracks the *Aronson* test, with two slight differences. According to new York law, a demand would be futile if a complaint alleges with particularity that:

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[92] Teamsters Union 25 Health Services & Insurance Plan v. Baiera, C.A. No. 9503-CB (Del. Ch. Jul. 13, 2015).
[93] *Id.*; *see also* Joseph M. McLaughlin, *infra* note 94 ("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, approval by Orbitz's audit committee [was required] . . . because of Travelport's significant equity interest in Orbitz.").
[94] Joseph M. McLaughlin, *Shareholder Derivative Actions and Demand Futility*, SIMPSON THACHER & BARTLETT LLP (Aug. 13, 2015), https://www.stblaw.com/docs/default-source/default-document-library/corporate-litigation-shareholder-derivative-actions-and-demand-futility-(8-13-2015).pdf?sfvrsn=0&id=772cdc0e-743d-6a02-aaf8-ff0000765f2c/ ("[O]nly a third of the nine-member Orbitz board, the three-member audit committee, was directly involved in approving the Travelport agreement . . . .").
[95] *See* United Food, *infra* note 149.
[96] *See infra* Chap. *3.1*. Risk of Facing Personal Liability – Exculpated Care Claims.
[97] *See supra note* 58 and accompanying text (states not allowing plaintiffs to plead futility of demand).
[98] *See infra* notes 127 & 128 and accompanying text (about plaintiffs' preference not to make a demand).
[99] Marx v. Akers, 88 N.Y.2d 189 (1996).

- A majority of the directors are interested in the challenged transaction;[100]
- The directors failed to inform themselves about the transaction to a degree reasonably appropriate under the circumstances;[101]
- The challenged transaction was so egregious on its face that it could not have been the product of sound business judgment of the directors.[102]

What emerges from an analysis of these three prongs is that they leave slightly less space to the court's discretion (Justice Smith criticized *Aronson* as being "overly subjective"[103]), than in Delaware's standard. First, the adherence to the standard of process due care[104] is an explicit requirement, different from *Aronson*'s second prong in which the same rationale is encompassed in the concept of "failure to receive the protection of the business judgment rule."[105] Even though coming from a different authority, the validity of such a reference to the standard of care has been recently put into question by the Delaware Chancery Court in deciding *United Food*, as will be discussed in the following section. Second, there is an allusion to the doctrine of corporate waste in *Marx*'s third prong (the word "egregious"), which addresses the plaintiff's complaint in the specific case that challenged the excessiveness of director compensation, a theme which has been recently been brushed up in *Feuer v. Redstone*,[106] albeit in a different jurisdiction. In this case, the Delaware Chancery Court itself acknowledged the rareness of successfully establishing claims for waste,[107] thus frequently deciding to defer to the board's decisions regarding employee compensation, unless the decision was so egregious that it could not have been based on a "valid assessment of the corporation's best interests."[108]

Both these divergences from Delaware's standard really point to the same rationale, namely that when a transaction amounts to either a breach of duty of care or to waste/unjust enrichment, the threat of being found personally liable[109] for its approval may neutralize directors' impartiality in evaluating a demand, thus making it superfluous to make one in the first place.

On the other side of the aforementioned continuum – very close to universal demand states, but still on the inside – lies Florida. Its corporate statute, the FBCA (Florida Business Corporation Act), basically tracks the principles stated in the MBCA, including the requirement that prospective plaintiffs make a

[100] *Id*. at 200.
[101] *Id*.
[102] *Id*. at 201.
[103] *Id*. at 196.
[104] *See infra* note 171 and accompanying text (about *Van Gorkom* and process due care).
[105] *See* Michele M. Schaeffer, *supra note* 72.
[106] Feuer v. Redstone, C.A. No. 12575-CB (Del. Ch. Apr. 19, 2018).
[107] *Id*. ("[A] transaction resulted in the corporation receiving consideration so inadequate in value that no person of ordinary, sound business judgment would deem it worth what the corporation has paid . . . and such circumstances are present rarely.").
[108] *Id*. at 10.
[109] *See* Paul D. Brown, Feuer v. Redstone: *The Delaware Court of Chancery Provides Guidance on Director Interest in The Demand Futility Context*, 32 INSIGHTS, Jun. 2018, at 12 ("[F]inding that the plaintiff had alleged particularized facts that certain payments constituted waste and that, accordingly, the directors faced a risk of liability on the underlying claims, such that demand would be excused.").

demand upon the board of directors in every case,[110] and that they wait 90 days before commencing the action (unless the corporation would otherwise suffer irreparable harm).[111] Only in the recent update of the statute (January 2020), a futility exception to the universal demand requirement (which was in place since 1990[112]) has been explicitly provided for,[113] although state courts had frequently applied one in the face of a clear statutory language to the contrary.[114]

Even though courts have not had the opportunity yet to set out the standard which will be used in deciding when demand may be excused as futile, we can expect that it will essentially follow the Delaware approach,[115] especially since there are other precedents of Florida's deference to Delaware law (like, for example, the prompt adoption of the Trulia standard in *Griffith v. Quality Distribution, Inc.*[116]).

2.3. Criticism

Over the years the regime of demand futility has evolved into the pivotal issue for a prospective plaintiff to pursue a derivative claim in the name of his company, at least in the jurisdictions which allow such an exception to the general demand requirement.[117] Along with its centrality, the critiques which it has attracted have obviously grown as well. To that, there is no shortage of followers of said criticism. Suffice it to say that both the American Law Institute (although its "Principles of Corporate Governance" are not a statutory source of corporate law) and the American Bar Association's Model Business Corporation Act (adopted, at least in some of its parts, by more than 30 U.S. states[118]) currently exclude the possibility that a

[110] FLORIDA BUSINESS CORPORATION ACT § 607.0742 ("A complaint in a proceeding brought in the right of a corporation must be verified and allege with particularity the demand, if any, made to obtain the action desired by the shareholder from the board of directors.").
[111] FLORIDA BUSINESS CORPORATION ACT § 607.0742(b) ("If such a demand was made, why irreparable injury to the corporation or misapplication or waste of corporate assets causing material injury to the corporation would result by waiting for the expiration of a 90-day period from the date the demand was made.").
[112] FLORIDA BUSINESS CORPORATION ACT § 607.07401 (previous version not allowing for a futility exception); *see also* Etan Mark & Steven D. Weber, *infra* note 114 ("The prior version of Florida's demand rule, enacted in 1990, similarly provided that a party must plead in their complaint that a demand was made prior to commencing a derivative action.").
[113] FLORIDA BUSINESS CORPORATION ACT § 607.0742(c) ("The reason or reasons the shareholder did not make the effort to obtain the desired action from the board of directors or comparable authority.").
[114] Etan Mark & Steven D. Weber, *Resistance is Futile: The Myth of Demand Futility*, 88 FLA. B.J., May 2014, at 10 ("Florida courts continue to recognize such an exception, even though the text of Florida's demand rule appears to be consistent with the demand rules of those states that do not recognize such an exception."); *see, e.g.*, McDonough v. Americom International Corporation, 151 F.R.D. 140 (M.D. Fla. 1993) ("[T]he plaintiffs plead that a demand would have been futile because the board of directors consisted of defendant Tatum and two other persons under his dominion and control.").
[115] *See* John E. Clabby, *Florida Is Now a Demand Futility State for Shareholder Derivative Actions*, CARLTON FIELDS (Jan. 14, 2020), *available at* https://www.carltonfields.com/insights/publications/2020/florida-is-now-a-demand-futility"-state-for-shareh ("It may be expected that Florida courts will follow the *Aronson* scheme for two reasons. First, Florida courts often refer to Delaware law as persuasive authority when Florida does not have law on the subject . . . Second, the Aronson test has been well developed over 35 years and provides relatively clear rules of decision where it applies.").
[116] Griffith v. Quality Distribution, Inc., No. 2D17-3160, 2018 WL 3403537 (Fla. Dist. Ct. App. Jul. 13, 2018) ("In re Trulia standard is applicable in Florida."); *see also* Pierluigi Matera & Ferruccio M. Sbarbaro, *From* Trulia *to* Akorn*: A Ride on the Roller Coaster of M&A Litigation*, 44 Del. J. Corp. L. 61, 79 (Jan. 13, 2020), *available at* https://ssrn.com/abstract=3518183 ("Florida, California, and Connecticut, for instance, adopted the *Trulia* standard.").
[117] *See supra* note 58 (states not allowing plaintiffs to plead futility of demand).
[118] *See, e.g.*, Stephen M. Bainbridge, *A Map of Model Business Corporation Act States*, PROFESSORBAINBRIDGE.COM (Apr. 11, 2013), *available at* https://www.professorbainbridge.com/professorbainbridgecom/2013/11/a-map-of-model-business-corporation-act-states.html/.

prospective plaintiff could avoid making a demand by pleading futility,[119] although both allow an exemption to said requirement in cases where irreparable injury would result to the corporation.[120]

Holding that federal courts were free to adopt their own requirements regarding demand (and eventually its excusal), Circuit Judge Frank H. Easterbrook openly advocated the adoption of American Law Institute's universal demand proposal.[121] In his opinion in *Kamen v. Kemper*,[122] he once again[123] described the futility regime as being a promoter of ambiguity, thus being costly and inefficient[124] (since plaintiffs, defendants and their attorneys have to concentrate on it before even getting to discuss the central claim). Requiring that demand be made in all cases (i.e. adopting ALI's proposal) would not only put a stop to this, but would even promote consistency when speaking of standards of judicial review. In Delaware or New York, for example, there is a clear link between the making (or not making) of a demand and the standard of review which will be used by the court[125] in analyzing the board's decision. Adopting ALI's universal demand in federal court would sever such a link because the presence of a demand would not affect the standard of review,[126] thus making it easier to predict how a case will be judged (for example for planning purposes). It must be added that, due to this link, plaintiffs rarely (if ever) choose to make a demand in states allowing for demand futility. Which is understandable[127] given the (Delaware) principle that making a demand corresponds to conceding that (the majority of) the board receiving it is independent, practically getting a step closer to the dismissal of the suit[128] by the court. Judge Easterbrook concluded by underlining that the aforementioned opinion doesn't mean to take out of the equation the scrutiny of the independence, disinterestedness and good faith of directors: it will just come, if necessary, at a later stage of the litigation[129] (by making a demand, and not instead of).

Michael P. Dooley exposed another negative aspect of the futility exception, namely that it is superfluous.[130] The same tradeoff between authority and accountability, in fact, is involved in various other

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[119] ALI PRINCIPLES OF CORPORATE GOVERNANCE § 7.03(b); MODEL BUSINESS CORPORATION ACT § 7.42.
[120] *Id*.
[121] ALI PRINCIPLES OF CORPORATE GOVERNANCE § 7.03(b).
[122] Kamen v. Kemper Financial Services, Inc., 908 F.2d 1338 (7th Cir. 1990).
[123] *See* John C. Coffee, *infra* note 134.
[124] Id. at 1342 ("[T]he futility exception to the demand rule has produced gobs of litigation."); *see also* ALI PRINCIPLES OF CORPORATE GOVERNANCE § 7.03(b) cmt. a at 65 ("[T]he futility exception is ambiguous in scope and has proven a prodigious generator of litigation.").
[125] *See* Kamen v. Kemper, *supra* note 122 at 1344 ("Delaware's link between the making of a demand and special deference to the board's decision not to sue."); *Id*. ("When the standard of review depends on the existence of a demand, plaintiffs have extraordinarily strong reasons not to make a demand, and corporations extraordinarily strong reasons to insist on one.").
[126] ALI PRINCIPLES OF CORPORATE GOVERNANCE § 7.03(b) cmt. a at 65 ("The need for demand and the standard of judicial review are logically very distinct.").
[127] *See* Kamen v. Kemper, *supra* note 122 at 1343 ("No wonder plaintiffs stoutly resist making demands.").
[128] *Id*. at 1344 ("Where futility exception is possible, shareholders rarely make a demand, because tendering a demand to the board puts the plaintiff out of court under Delaware law.").
[129] *Id*. at 1347 ("We conclude that precedent does not prevent us from holding that claims of futility should be tested by making a demand rather than by arguing about hypotheticals. If the firm declines to sue, the court can decide whether the board's decision is entitled to respect under state corporate law . . . .").
[130] *See* Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 502 (1992) ("The court's resolution demonstrates the parallels between demand-excused and other self-interest cases, and, indeed, the similarities among all basic corporate governance issues when viewed in terms of the Authority/Responsibility tradeoff."); *Id*. at 501 ("[I]f the plaintiff pleads sufficiently particularized facts to raise a reasonable doubt concerning the board's disinterestedness or independence, he also has demonstrated that demand should be excused . . . [therefore he] is free to prosecute the claim on behalf of the corporation. As in

self-interest cases: they just belong to different situations and/or stages of the litigation.[131] An interested board defending a conflicted transaction as being anyhow "in the best interests of the corporation,"[132] would be subject to the same kind of analysis of *Zapata*'s special litigation committee.[133]

Another influential critic of the futility regime is John C. Coffee.[134] He too stated that by contributing to the creation of confusion and uncertainty, it does nothing but increase costs and inefficiencies due to increases in collateral litigation and waste of judicial resources.[135]

This analysis has been even quoted by Bradley T. Ferrell,[136] in his work defending the universal demand requirement of American Law Institute's approach.[137] In his words, always having to make a demand would allow courts to focus "on the appropriate issues", namely the board's (or committee's) reasons for rejecting the demand, and whether the underlying transaction (i.e. the injury purported by plaintiffs) really went against the interests of the corporation. Plus, he contends, there is practically no reason not to adopt a universal demand rule: on one side, it is a relatively low-cost procedure for shareholders, and on the other, it "incorporates the strengths of the Delaware approach without incorporating its weaknesses,"[138] since the refusal of a demand by an interested board would have no validity in every case.[139]

Are there any advocates of the futility regime? Of course, like in every significant debate, the answer is yes. The first authority cited in this chapter, Judge Frank H. Easterbrook, has been contradicted himself by none other than the Delaware Supreme Court (in *Kamen*'s reversal[140]). The Court recognized that a universal demand rule would objectively concur to cutting the "high collateral litigation costs associated with the

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the case of loyalty issues, Responsibility trumps Authority: a board acting out of self-interest is not promoting the interests of the shareholders and there is no reason to preserve its authority.").

[131] *Id.*; *see also* STEPHEN M. BAINBRIDGE, *infra* note 144 and accompanying text.

[132] *See* Zapata Corporation v. Maldonado, *supra* note 65 at 785; *see also* Michael P. Dooley, *supra* note 130 at 502 ("*Zapata* offers limited recognition to the authority of the SLC in the sense that it recognizes that the SLC is a proper representative of the corporation in the same way that an interested board may legitimately assert that a conflicted interest transaction is nonetheless in the best interests of the corporation.").

[133] *Id.* ("[T]he fact that the board was originally disqualified by self-interest, coupled with the fact that the SLC members were appointed by directors disabled from acting on the matter at issue, raises a Responsibility issue of such magnitude that an independent judicial determination of the corporation's best interests is warranted . . . in much the same way that a court will review a conflicted interest transaction for fairness [in the context of loyalty issues].").

[134] *See, e.g.*, John C. Coffee, Jr., *Derivative Litigation Under Part VII of the ALI Principles of Corporate Governance: A Review of the Positions and Premises*, CURRENT ISSUES IN CORPORATE GOVERNANCE, at 237, 245 (1995) ("Delaware's demand rule also results in a substantial amount of collateral litigation and sometimes can be a trap for the unwary.").

[135] *Id.* at 254 ("[T]his issue of whether demand is excused under Delaware law spawns several other issues that create litigation and consume judicial resources, such as whether a demand need be made, what demand concede, what issues the demand did or did not relate to, and whether shareholders who did not make a demand can attack the board's independence when other shareholders did make a demand, etc.").

[136] Bradley T. Ferrell, *A Hybrid Approach: Integrating the Delaware and the ALI Approaches to Shareholder Derivative Litigation*, 60 OHIO ST. L.J. 241, 272 (1999) ("[U]niversal demand reduces substantial amount of collateral litigation that arises in determining when demand is excused due to futility."); *Id.* at 274 ("The Delaware approach is too costly and inefficient.").

[137] *Id.* ("Universal demand is best."); *Id.* at 252-253 ("The ALI approach v. the Delaware approach . . . Section 7.03 of the ALI Principles sets forth a universal demand rule . . . .").

[138] *Id.* at 274 ("It still . . . retains many of the benefits that demand provides, such as giving notice to the corporation of the shareholder's allegations and enabling the corporation to conduct intracorporate dispute resolution that could eliminate the need for litigation.").

[139] *Id.* ("[T]he ALI's universal demand rule also has this requirement of board disinterestedness and independence built into its standard. Instead of excusing demand where a majority of the board is interested, the ALI standard requires demand, but gives the board's response to that demand no legal weight.").

[140] Kamen v. Kemper Financial Services, Inc., 500 U.S. 90 (1991).

demand futility doctrine,"[141] because by forcing would-be derivative plaintiffs to exhaust their intracorporate remedies before filing suit, it would spare both the courts and the parties the expense "associated with the often protracted threshold litigation that attends the collateral issue of demand futility."[142] But the lower court's (Easterbrook's Seventh Circuit) opinion has been nonetheless opposed: nothing prohibits directors from trying to internally address the matter even after a shareholder files a complaint in which demand is excused as futile and costs are unlikely to be cut in a significant manner. That's because the review standards the concept of demand futility entails, namely analyzing the independence and disinterestedness of directors, are still the same, they just "shift the focus from the question whether demand is excused to the question whether the directors' decision to terminate the suit is entitled to deference."[143]

Or, as Stephen M. Bainbridge put it, it simply moves the tracing of those cases in which conflicted interests have compromised the directors' decision-making processes to a later stage of the judicial process.[144] The scope is always balancing the board's authority and the need to hold them responsible in case its members have misused said authority for their personal benefit at the expense of shareholders. Demand futility is just the "vehicle"[145] (for example) New York and Delaware utilize.

The critiques moved towards the laboriousness, the uncertainty and the costs generated by the regime of the futility of demand are not only numerous, but also quite rational. Nevertheless, courts (especially in Delaware, New York and surprisingly Florida[146]) are continuing to allow shareholder-plaintiffs to exploit such an exception, and, in some cases, they are even continuing to develop[147] such a "costly, inefficient and superfluous" standard.[148]

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[141] *Id.* at 106.
[142] *Id.*
[143] *Id.*
[144] STEPHEN M. BAINBRIDGE, *supra* note 2, at 273 ("Replacing the demand futility inquiry with a universal demand requirement does not eliminate the need to separate out those cases in which conflicted interests have so tainted the board's decision-making processes as to preclude giving the resulting decisions the deference usually accorded them by corporate law . . . it simply shifts the task of effecting such a separation to a different stage of the process.").
[145] *Id.*
[146] *See* John E. Clabby, *supra* note 115 and accompanying text (even being a MBCA state, Florida recently allowed for a futility exception); *see also supra* Chap. 2.2. Differences Among Jurisdictions (N.Y. – Florida).
[147] *E.g.* United Food, *infra* note 149.
[148] *See, e.g.*, notes 124, 130 & 135 and accompanying text (about the critiques of the futility regime).

III. UNITED FOOD

In 2010, the founder, president and chief operative officer of Meta Platforms, Inc. (at the time, Facebook, Inc.) Mark Zuckerberg, followed other ultra-wealthy individuals (like Bill Gates and Warren Buffett) in the pursuit of the "Giving Pledge", a movement that encouraged business leaders to donate their wealth to philanthropic causes. In 2015, in order to achieve such an objective, he began working on a plan to sell a significant portion of his stock, although trying to avoid losing his majority voting control, which would have happened if he sold more than $3 to $4 billion worth of shares (he aimed at donating $2 to $3 billion, annually). The solution his counsel came up with was the issuing of a new class of non-voting stock, that he could sell without significantly affecting his voting power. Even though the board had established a special committee composed of (purportedly) independent directors to review, approve and negotiate it, said reclassification was challenged by minority shareholders in a class action (composed of 13 different cases), claiming that it would (arguably) affect their interests in a negative manner. Zuckerberg and the board decided to abandon the plan. The amounts spent on defending and mooting the reclassification, on attorneys' fees and on reimbursing the plaintiffs' counsel (under the corporate benefit doctrine), were the object of the derivative action brought by the United Food and Commercial Workers Union and Participating Food Industry Employers Tri-State Pension Fund ("Tri-State") in the case which will introduce the new demand futility test.

3.1. A New Standard for Demand Futility

The standard utilized by Delaware courts in evaluating whether demand may be (or may have been) excused as futile has been recently shaken-up in *United Food.*[149] The two leading cases and their respective tests[150] have been combined, in a decision which potentially signals the latest shift in Delaware's race-to-the-bottom,[151] and another clear example of its markedly pro-director stance. The new test, to be applied on a director-by-director basis, is composed of the following three parts, which aim at discovering:

- "Whether the director received a material personal benefit from the alleged misconduct that is the subject of the litigation demand;"[152]
- "Whether the director would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand;"[153]
- "Whether the director lacks independence from someone who received a material personal benefit from the alleged misconduct that is the subject of the litigation demand or who would

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[149] United Food and Commercial Workers Union and Participating Food Industry Employers Tri-State Pension Fund v. Zuckerberg, C.A. No. 2018-0671-JTL (Del. Ch. Oct. 26, 2020).
[150] Aronson v. Lewis, *supra* note 57; Rales v. Blasband, *supra* note 85.
[151] *Cf.* Pierluigi Matera, *Delaware's Dominance, Wyoming's Dare. New Challenges, Same Outcome?*, 27 FORDHAM J. CORP. & FIN. L. 1, 14-17 (Aug. 28, 2021), *available at* https://ssrn.com/abstract=3763106 ("Some commentators contend that Delaware won a race-to-the-bottom and continues to prevail in a contest to provide management-friendly legislation and case law, since this jurisdiction has a strong interest in retaining its dominance and is very focused in appeasing incorporators.").
[152] *See* United Food, *supra* note 149.
[153] *Id.*

face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand."[154]

Why couldn't either of the previous tests be used in assessing the propriety of Tri-State's (i.e. the plaintiff's) decision not to make a demand on the board? The question is easy to be answered for *Rales*, because none of the conditions which renders it applicable[155] were satisfied by Facebook's board at the time the complaint was filed (i.e. there was no majority of new directors). And what about *Aronson*? Its technical applicability was also called into question by Vice Chancellor Travis Laster. First of all, he acknowledged that, due to its "narrow and inflexible application," it was appropriate to consider the *Rales* test the general rule which encompasses *Aronson* as a special case[156] and not vice versa, adhering to a position which had already been advocated by Stephen M. Bainbridge.[157] Originally, it was the *Rales* test to be viewed as a supplement to a more generally applicable *Aronson* standard, but now jurisprudence has shown just the opposite, namely that the *Rales* test encompasses the *Aronson* standard and thus should be the general test.[158]

Three factors undermined *Aronson*'s analytical framework's pertinence to the case at bar: the board had been partly replaced (only three of the nine directors were new), one of the current directors had not approved the underlying transaction (he had abstained from voting on the Reclassification), and the rationale behind the second prong (rebutting the business judgment rule by showing a breach of the duty of care) had been sterilized by a subsequent development of Delaware's policy, namely the adoption of director exculpation statutes,[159] as a response to the seminal case *Smith v. Van Gorkom*.[160]

If it weren't for this last element, that is, the enactment of Section 102(b)(7), which rendered care claims a non-issue when considering directors' impartiality in considering a litigation demand,[161] the Court would have probably applied *Rales*, like it did in other recent cases. For example, in both *Zynga*[162] and *Uber*,[163] the Chancery Court acknowledged that none of the exceptions to the application of *Aronson* set out

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[154] *Id.*
[155] *See supra* notes 87, 88 & 89 and accompanying text (situations in which to apply *Rales* instead of *Aronson*).
[156] *See* United Food, *supra* note 149, at 18-19.
[157] *See* Stephen M. Bainbridge, *A Brief Essay on Delaware Vice Chancellor Laster's Argument for Replacing Aronson with Rales*, ProfessorBainbridge.com (Oct. 27, 2020), *available at* https://www.professorbainbridge.com/professorbainbridgecom/2020/10/a-brief-essay-on-delaware-vice-chancellor-lasters-argument-for-replacing-aronson-with-rales.html/ ("In my Business Association class, I have often argued that the Delaware Supreme Court should overrule *Aronson* and adopt *Rales* as the general standard.").
[158] MARC J. LANE, REPRESENTING CORPORATE OFFICERS AND DIRECTORS AND LLC MANAGERS 5-100 to 5-102 (3d ed. 2019, Supp. 2021-2) ("The court instead applied the *Rales* test and noted that, while a strict application of precedent to the circumstances of the case required the application of *Aronson*, the standard could not accommodate an analysis of director conflicts outside of the challenged decision. According to the court, this limitation of the *Aronson* test necessitates reevaluation of the general standard for analyzing an allegation of demand futility.").
[159] 8 DEL. C. § 102(b)(7), *available at* https://delcode.delaware.gov/title8/c001/index.html; *see generally* Carl Samuel Bjerre, *Evaluating the New Director Exculpation Statutes*, 73 CORNELL L. REV. 786 (1988) ("A novel species of charter provision . . . that eliminates or limits a director's liability for breach of his fiduciary duty of care.").
[160] Smith v. Van Gorkom, *supra* note 80.
[161] *See* Stephen Blake et al., *Recent Delaware Derivative Stockholder Litigation Developments*, HARV. L. SCH. F. ON CORP. GOV. (Dec. 1, 2021), *available at* https://corpgov.law.harvard.edu/2021/12/01/recent-delaware-derivative-stockholder-litigation-developments/ ("[T]he enactment of Section 102(b)(7) of the Delaware General Corporation Law . . . 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.").
[162] Sandys v. Pincus, 152 A.3d 124 (Del. 2016).
[163] McElrath v. Kalanick, No. 181-2019 (Del. 2020).

in *Rales* strictly applied to said cases.[164] But, since both boards' composition had changed "dramatically"[165] (i.e. a majority of the transaction board was different from the demand board[166]), the result was nonetheless the involvement of the standard set out in *Rales*.

3.2. Risk of Facing Personal Liability – Exculpated Care Claims

As described earlier, *Aronson* and *Rales* already had a central difference which has been carried over to the new test, namely their focus. Both obviously aim at answering the same question (i.e. whether the board can be trusted in honestly deciding whether the plaintiff's claims should be pursued or dismissed by the corporation), but the former gets there indirectly – by focusing on the approval of the underlying transaction – and the latter directly inquires whether the board could impartially evaluate the demand. *Aronson*'s second prong ("the decision was otherwise the product of sound business judgment") is nothing else than a proxy for the risk of director liability:[167] supposing that there has been a breach of fiduciary duty (sufficient to lift the protection granted by the business judgment rule), directors having approved such a breach could arguably fear that an eventual suit could result in them being held personally liable, thus tainting their ability to make an unbiased decision in choosing whether to go on with the suit itself. But would the directors' decision in such a case still be biased if they were to be protected from liability, for example by a charter provision? That's exactly what Vice Chancellor Laster meant when he said that "changes in the law eroded the ground upon which the *Aronson* framework rested."[168] After the introduction of Section 102(b)(7) exculpation provisions in 1986 (i.e. after *Aronson*'s decision), claiming that a director breached his duty of care was no longer an obstacle to the board's ability to impartially consider a demand: why should a director unbiasedness be questioned, if he wouldn't face personal liability in any case? The legal environment changed since, thus it is logical to let standards of review adapt to it: the Delaware Court of Chancery (adhering to a stance already adopted in 2015 in *Cornerstone*[169]) held that exculpated breach of

[164] *See* John Mark Zeberkiewicz & Stephanie Norman, *Delaware Supreme Court Revisits Director Independence in Considering Derivative Demands*, 31 INSIGHTS, Feb. 2017, at 3 ("The Court indicated that *Aronson*, the application of which relates to the board that approved the transaction rather than the board charged with deciding how to respond to a demand, introduced various challenges . . . none of the exceptions to the application of *Aronson* identified in *Rales* applied by its terms.").
[165] *See* John Mark Zeberkiewicz & Brian T.M. Mammarella, *Revisiting Director Independence and Disinterestedness in the Demand Futility Context*, 34 INSIGHTS, Mar. 2020, at 3 ("By the time the complaint was filed, the composition of the board had changed dramatically."); *Id*. ("Given the shift in board composition between the time of the transaction's approval and the time the complaint was filed – only three persons who served on the Transaction Board continued to serve on the eleven-person Demand Board – the Court applied the standard enunciated in *Rales v. Blasband*.").
[166] *See* John Mark Zeberkiewicz & Stephanie Norman, *supra* note 164 ("[T]he Court found that enough of the interested members of that board were replaced and an additional director was added – i.e. the board in place at the time the complaint was filed, or the demand board – was composed of a majority of directors who had received no personal benefit from the underlying transaction.").
[167] *See* Stephen M. Bainbridge, *supra* note 157 ("[T]he Aronson test has always been an awkward way of getting at the core problem in the derivative suit context.").
[168] *See* United Food, *supra* note 149, at 23.
[169] *In re* Cornerstone Therapeutics Inc., Stockholder Litigation, No. 564, 2014, 2015 WL 2394045, at 5 (Del. 2015) ("Plaintiffs must plead a non-exculpated claim for breach of fiduciary duty against an independent director protected by an exculpatory charter provision, or that director will be entitled to be dismissed from the suit.").

care claims do not per se render demand futile (as per Tri-State's allegations), since they no longer represent a threat that neutralizes director discretion.[170]

Liability limitation statutes have been introduced as a reaction to the decision of Smith v. Van Gorkom, which imposed liability on directors who failed to adequately inform themselves about a transaction they approved (ignoring the so called process due care[171]). Delaware directors resigned en masse and fewer people were willing to accept such a position,[172] aggravated by the fact that D&O insurance became costlier and difficult to get.[173] Plus, overspending on information was a concrete risk, since the cost of its production (the more, the better) had to be borne by the company, while its benefits (i.e. the "insurance" against being accused of failing to adequately inform oneself) were to be received by directors.[174] To steer its policy back towards director primacy, Delaware allowed corporations to limit directors' liability for specified kinds of conduct (breaches of the duty of loyalty and good faith, for example, are not covered – though they are in Nevada[175]), in order to avoid discouraging managerial risk-taking, which, as per the business judgment rule's basic explanation, serves the function of preserving the fundamental value of director discretion,[176] by making sure that shareholders and courts will not be too intrusive in the board's decision-making process.[177]

3.3. The Underlying Transaction – External Stakeholders' Interests

The transaction challenged by plaintiff Tri-State is an issuance of a new class of non-voting stock ("reclassification") which would have resulted in Mark Zuckerberg retaining control on the company, despite having sold his stock (or, at least, a significant part of it) in return for cash. The objective Zuckerberg wanted to achieve was donating a great part of his wealth to philanthropic causes, as a part of his commitment towards the "Giving Pledge."[178] His wealth, though, principally comes from the value of Meta

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[170] Id.; *see also supra* note 159 and accompanying text (about the introduction of exculpatory clauses).

[171] *See* Smith v. Van Gorkom, *supra* note 80, at 273 ("Directors who fail to act in an informed and deliberate manner may not assert the business judgment rule as a defense to care claims.").

[172] *See* Bernard S. Sharfman, *The Enduring Legacy of* Smith v. Van Gorkom, 33 DEL. J. CORP. L. 287, 301 (2008) ("[S]ome directors were resigning from their board positions and others would not even consider board service for fear of the potential personal liability for being uninformed when making a corporate decision.").

[173] *See generally* Roberta Romano, *What Went Wrong with Directors' and Officers' Liability Insurance?*, 14 DEL. J. CORP. L. 1 (1989).

[174] *See* STEPHEN M. BAINBRIDGE, *supra* note 2, at 153 ("Who pays the bill if the director is found liable for breaching the duty of care? The director. Who pays the bill for hiring lawyers and investment bankers to advise the board? The corporation and, ultimately, the shareholders.").

[175] *See generally* Michal Barzuza, *Market Segmentation: The Rise of Nevada as a Liability-Free Jurisdiction*, 98 VA. L. REV. 935, 941 (2012) ("Nevada has shielded corporate actors from liability for various acts and omissions, allowing officers and directors to avoid liabilities that are considered almost axiomatic, such as those for breaches of the duty of loyalty, acts or omissions not in good faith, and transactions from which an officer or a director derived an improper personal benefit.").

[176] *See* Michael P. Dooley, *supra* note 130, at 469-470 ("The business judgment rule is a common law rule used by the courts to minimize the number of shareholder complaints that receive judicial review . . . protecting the value of board authority.").

[177] *See* Bernard S. Sharfman, *supra* note 172, at 302 ("When moving away from the value of authority and toward the value of accountability, courts must be careful not to overcorrect. Such an overcorrection occurred in *Van Gorkom*.").

[178] *See* United Food, *supra* note 149, at 3 ("In December 2010, Zuckerberg took the Giving Pledge. Championed by Bill Gates and Warren Buffett, the Giving Pledge calls on wealthy business leaders to donate a majority of their wealth to philanthropic causes. Zuckerberg announced that he would begin his philanthropy early in his life.").

(then, Facebook) stock he owns: to convert it into cash (and be able to make donations), he would have had to sell it, thus losing the position of majority control in the company he himself founded. How did this imply a detrimental effect on the minority shareholders? Their voting power would have obviously been diluted. But the deal here is that the reason for initiating such a plan in the first place, is giving a priority to – yes, admittedly Zuckerberg's, but ultimately – interests different from that of shareholders.

The shareholders' wealth maximization norm has seen some critiques emerge in relatively recent times: for example the proposal of a congressional bill by Sen. Elizabeth Warren in 2018 (the Accountable Capitalism Act[179]) aimed at shifting corporate priorities from a univocal focus on maximizing shareholder value to a broader balancing of external stakeholders' interests (for example, employees, customers and communities). Or, the adoption by a majority of U.S. states[180] of constituency statutes, allowing directors to consider the long-term consequences of their decisions on all corporate stakeholders, even if it means choosing a path which is second-best for shareholders. Delaware (Meta's state of incorporation), though, is not one of these states:[181] its historical commitment[182] towards director discretion and the business community (by focusing on maximizing shareholder value) would clash with such a shift in policy. At least for a for-profit organization, the very purpose of a Delaware business corporation is that of "maximizing the wealth of its stockholders."[183] In Stephen M. Bainbridge's words, a company wanting to opt out of this default rule could (and should) simply choose to incorporate as a "public benefit corporation."[184] Former Chief Justice of the Delaware Supreme Court Leo E. Strine Jr. is also a notable advocate of the abolishment of the shareholder wealth maximization norm.[185] Recently, he argued that policymakers should avoid

[179] ACCOUNTABLE CAPITALISM ACT, S. 3348, 115th Cong. (2018) ("A United States corporation shall have the purpose of creating a general public benefit . . . In discharging their duties of their respective positions, and in considering the best interests of a United States corporation, the board of directors . . . shall manage or direct the business and affairs of the corporation in a manner that seeks to create a general public benefit and balances the interests of the shareholders with the best interests of persons that are materially affected by the conduct of the corporation.").

[180] *See, e.g.*, Jitendra Aswani et al., *The Cost (and Unbenefit) of Conscious Capitalism*, SSRN (Sep. 16, 2021), *available at* https://ssrn.com/abstract=3926335, at 35/36, figure 1 & table 1 (map and table of states adopting constituency statutes, most notably with the exception of Delaware and California).

[181] *Id.*

[182] *See* Pierluigi Matera, *supra* note 151, at 5 ("[M]anagers and investors rely upon Delaware's commitment towards the business community: Delaware lawmakers respond promptly to the needs of corporate constituencies; efficiency and predictability of its judicial system permit business to thrive and flourish.); *Id.* at 12 ("Delaware's courts formulated, developed, and virtually imposed some of the most notable doctrines in American corporate law on other jurisdictions. These doctrines also set a very pro-director corporate law that is highly desirable for incorporators.").

[183] Lawrence A. Hamermesh & Jack B. Jacobs, *Lyman Johnson's Invaluable Contribution to Delaware Corporate Jurisprudence*, 74 WASH L. REV. 909, 933-34 (2017) ("We maintain that for an investor who has not expressly manifested a contrary preference, the purpose of the Delaware business corporation is maximization of the wealth of its stockholders.").

[184] Stephen M. Bainbridge, *A Delaware Corporation Cannot Opt Out of the Shareholder Wealth Maximization Norm in Its Certificate of Incorporation*, PROFESSORBAINBRIDGE.COM (Aug. 10, 2020), available at https://www.professorbainbridge.com/professorbainbridgecom/2020/10/a-delaware-corporation-cannot-opt-out-of-the-shareholder-wealth-maximization-norm-in-its-ce.html/ ("All of which seems to be reinforced by Delaware's adoption of the public benefit corporation option. If somebody wants a Delaware corporation that has a purpose other than shareholder wealth maximization, they have to go the B Corp route.").

[185] *See* Leo E. Strine, Jr., *infra* note 186 ("[T]hose who say that corporate law requires that directors must, within the discretion afforded to them by positive law, make stockholder welfare the sole end of corporate governance are simply wrong and have misread the precedent.").

continuing to empower stockholders, because to do so would be "adverse to the best interests of society in having public corporations create wealth in a responsible and ethical fashion."[186]

So, on one side we have the personal desires of the person who founded and successfully guided Meta Platforms to admittedly being one of the most valuable companies in the world, on the other we have the negative effect these desires would have on suing minority shareholders. Could these two necessities be balanced? Or better, could the same objective (i.e. Zuckerberg's donations) be achieved in a less harmful way (for the minority)? Probably yes, since this is what happened in the end: notwithstanding the class action's dismissal, Zuckerberg sold approximately $5.6 billion in the three years following the abandonment of the reclassification plan, consequently donating the amounts received.[187] Another option (explicitly rejected by Zuckerberg's counsel as non-starter[188]), which had already been adopted by Google[189] in a similar context, could have been that of directly compensating minority shareholders for the ownership dilution they would have suffered, thus avoiding to extract a benefit at their expense, and to remove every doubt about the transaction's fairness.

Speaking of fairness, and coming the subject of the derivative suit brought by Tri-State, namely the attempt to recoup the amounts paid in connection with the mooting of the class action, an obvious question comes to mind. Given his central role in the underlying proposal, wouldn't it have been fair if Zuckerberg offered to pay these amounts personally (especially considering his disproportionately abundant personal wealth)? With the benefit of hindsight, we could hardly define the challenged conflicted-transaction as fair: more than 70% of minority shareholders voted against it,[190] and it would be difficult to explain the aforementioned reclassification as a decision aimed at furthering the corporation's interests, which independent directors, acting upon the matter before them in an entirely unbiased manner, would have reasonably approved. And here comes another theme worth discussing: although the proposed transaction did receive the approval of a special committee, the possibility that they nonetheless lack disinterestedness and independence is significant – given the potential involvement of some kind of structural bias, due to the presence of a charismatic figure who is not only the controller, majority owner, president and chairman of Meta Platforms, but also (and more importantly) its founder and the man behind the company's ideas, products and values.

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[186] Leo E. Strine, Jr., *Making It Easier for Directors to Do the Right Thing*, 4 HARV. BUS. L. REV. 235, 237 (2014) ("Because many of the most active stockholders have a short-term focus, giving them too much influence could negatively affect a board's ability to chart a long-term course that is both profitable for stockholders and respectful of the company's workers, consumers, communities, and the environment.").

[187] *See* United Food, *supra* note 149, at 13-14 ("Over the next sixteen months, Zuckerberg sold about 30.4 million shares for around $5.6 billion without losing control of Facebook.").

[188] *Id*. at 5 ("Simpson Thacher rejected as non-starters certain corporate governance concessions from the Google playbook, including a stapling provision that would have required Zuckerberg to sell a share of high-vote Class B stock each time he sold a share of non-voting Class C stock and a true-up payment to the Class A stockholders to compensate them for the dilution of their voting power.").

[189] *Id*. at 4 ("Google's reclassification led to shareholder litigation which ended with a settlement valued at $522 million.").

[190] *Id*. at 12-13 ("The shares voted in favor included Zuckerberg's holdings of 4 million Class A shares and 419 million Class B shares, which together constituted 4.7 billion votes. Excluding Zuckerberg's votes, the tally would have been around 453 million shares in favor and 1.5 billion against. Put differently, holders of more than 70% of the disinterested shares opposed the Reclassification.").

3.4. Independence From a Controlling Shareholder – The 800-pound Gorilla

Following *Rales* (and its implemented version, set out in this very case), director is deemed to be interested for demand futility purposes if he either has a material (i.e. financial) interest in the transaction which is not equally shared by shareholders,[191] or if he lacks independence[192] from someone having such a material interest (i.e. there exists a relationship of a bias-producing nature[193]). In several occasions, Delaware courts have underlined that to be considered non-independent, the relationship between the defendant director and the interested person must satisfy a materiality standard:[194] the plaintiff has the burden of proving that the ties between them are so important that he could not "objectively discharge his fiduciary duties."[195]

The Delaware Supreme Court (in the person of Justice Montgomery-Reeves) reaffirmed the lower court's decision (i.e. Vice Chancellor Travis Laster's) to dismiss Tri-State's complaint for failure to make demand on the board and/or adequately pleading demand futility.[196] This, in turn, means that of the nine-people board, the four directors under scrutiny[197] (Tri-State conceded that two of them would have been able to consider a demand; Facebook conceded that three of them would not have been able to impartially consider a demand, one of them being Zuckerberg himself[198]) were technically deemed to be independent and disinterested, according to the new standard for assessing demand futility.[199] Demand could not be excused under the first prong of the new test, since no one (other than Zuckerberg) was to receive a material personal benefit. The second prong does not excuse it either, since then-Facebook's charter contains a broad Section 102(b)(7) exculpation provision.[200] It all boils down to whether the directors in reality did lack independence from Zuckerberg in approving the challenged transaction, or to put it another way whether they really thought that the aforementioned reclassification was in the best interests of the corporation.

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[191] *See* Rales v. Blasband, *supra* note 85, at 936 ("The primary basis upon which a director's independence must be measured is whether the director's decision is based on the corporate merits of the subject before the board, rather than extraneous considerations or influences.").
[192] *Id*. ("To show a lack of independence, a derivative complaint must plead with particularity facts creating a reasonable doubt that a director is so beholden to an interested director that his or her discretion would be sterilized.").
[193] Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1050 (Del. 2004) ("To render a director unable to consider demand, a relationship must be of a bias-producing nature. Allegations of mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director's independence.").
[194] Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1167 (Del. 1995) ("A plaintiff seeking to show that a director was not independent must satisfy a materiality standard.").
[195] *Id*. ("The plaintiff must allege that the director in question had ties to the person whose proposal or actions he or she is evaluating that are sufficiently substantial that he or she could not objectively discharge his or her fiduciary duties.").
[196] United Food, *supra* note 149, at 63 ("A majority of the Demand Board is disinterested, independent, and capable of considering a demand. Demand thus is not excused, and the defendants' motion to dismiss under Rule 23.1 is granted.").
[197] *Id.* at 17 ("Thiel, Hastings, Bowles, and Desmond-Hellmann.").
[198] *Id*. ("Tri-State concedes on appeal that two of those directors, Chenault and Zients, could have impartially considered a litigation demand. And Facebook does not argue on appeal that Zuckerberg, Sandberg, or Andreessen could have impartially considered a litigation demand.").
[199] *See supra* note 196 (about the finding that directors were indeed independent).
[200] *See* United Food, *supra* note 149, at 17("[N]one of the remaining four directors obtained a material personal benefit from the alleged misconduct that is the subject of the litigation demand. Similarly, there is no dispute that Facebook has a broad Section 102(b)(7) provision.").

According to the Court and the new three-pronged test (with the concurrent application of the materiality standard[201]), yes. There are facts, plead by the plaintiff but rejected by the Court as non-sufficient to comply with the materiality standard, which would point to the technically independent directors being biased towards Mark Zuckerberg. Probably only in a slight manner, but possibly sufficient to feel obliged to go along with his proposal, out of respect or deference.[202] Among these facts we could for example cite a bias towards leaders/founders maintaining control of their companies (e.g. by Reed Hastings, founder of Netflix, Inc. or by Peter Thiel, co-founder of PayPal, Inc.[203]), or a bias towards similarly wealthy individuals committed to philanthropy[204] (Zuckerberg received public support and congratulation messages by other board members when he declared his adherence to the Giving Pledge[205]). Or else, taking into consideration Zuckerberg's of dominant position: who sincerely would reject or contrast a proposal by such a charismatic public figure? First of all just thinking of the psychological pressure[206] it may involve (probably, even I wouldn't personally be able to act unbiasedly, out of admiration/esteem), but even more so when thinking of the dominant position the company has in the market, together with the strong relationships with similar enormously valuable corporations (e.g. Netflix itself): wouldn't it be difficult – as a director – to make an impartial decision which could have an effect (even just a feared one) on future potential job positions/relationships as well?

Are there facts supporting said intuitions? For example, let's consider that the Special Committee having the task to set out the terms of the deal (composed of purportedly independent directors Bowles, Andreessen and Desmond-Hellman) didn't even try to negotiate with Zuckerberg. They adhered almost in full with his proposal, asking just for some minor concessions, like a provision aimed at discouraging Zuckerberg from leaving the company, despite clear indications that he never intended to do so.[207] Or else, they didn't even try to make the deal look fair to the minority: they could, for example, have insisted on a so-called stapling provision/transfer restriction (which would have forced Zuckerberg to sell one share of non-voting stock for every common share he sold) or some kind of true-up payment to compensate minority shareholders for the dilution of their voting power.[208]

In a similar situation,[209] in describing his influence over Tesla's board, Elon Musk (the founder, CEO and Product Architect of Tesla, Inc.) has been compared to an 800-pound gorilla,[210] by Chief Justice Leo E.

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[201] *See* Cinerama, *supra* notes 194 & 195.
[202] *See* Stewart, *supra* note 193, at 1051-52 ("[T]he non-interested director would be more willing to risk his or her reputation than risk the relationship with the interested director.").
[203] *See* United Food, *supra* note 149, at 19-20 ("Hastings as a Netflix founder is biased in favor of founders maintaining control of their companies . . . Thiel has a personal bias in favor of keeping founders in control of the companies they created.").
[204] *Id*. ("Hastings has publicly supported large philanthropic donations by founders during their lifetimes. Indeed, both Hastings and Zuckerberg have been significant contributors to a well-known foundation . . . .").
[205] *Id*. at 4 ("Bowles and Andreessen told Zuckerberg that they were proud of him for taking the Giving Pledge and announcing his plan to begin donating his wealth to philanthropic causes . . . At that time, Desmond-Hellman was the chief executive officer of the Gates Foundation.").
[206] *See* Julian Velasco, *supra* note 82 ("[P]sychological dependency upon or ties to the corporation's executives, particularly its chief executive . . . .").
[207] *Id*. at 8 ("On December 1, 2015, Zuckerberg announced his Giving Pledge through a Facebook post. He simultaneously affirmed that he would remain Facebook's CEO for many, many years to come.").
[208] *See supra* note 188 (about the concessions from Google in a similar transaction).
[209] Tornetta v. Musk, C.A. No. 2018-0408-JRS (Del. Ch. Sep. 20, 2019).

Strine, a title which would be exactly as adequate in describing Zuckerberg's influence over Facebook's board. In both cases the beneficiary of the challenged transaction is a controlling shareholder (Zuckerberg's ability to make donations and Musk's self-compensation scheme): thus, there is a potential risk that even technically-deemed independent directors might "owe or feel a more-than-wholesome allegiance to the interests of the controller, rather than to the corporation and its public stockholders."[211]

3.5. The Safety-Valve Function of *Aronson*'s Second Prong

And that's where the problem lies. The new demand futility test has lost what Lawrence A. Hamermesh defined the "safety valve function"[212] of *Aronson*'s second prong.[213]

Said test could probably be described as a sieve whose mesh is too big. Yes, it goes – like its predecessor *Rales*, and unlike *Aronson* – straight to the substance of the question,[214] due to its focus on assessing whether the board may impartially consider a demand (as opposed to analyzing the underlying transaction). It's even easier to apply, due to its universal nature.[215] But *United Food* would suggest that there are cases in which it may not be so appropriate, since there is a possibility that it entirely misses the problem.

The board (or, at least, a majority of it) has been found to be technically independent and disinterested, thus being deemed able to consider a litigation demand, had it been made by plaintiff. Since Tri-State hadn't made one (and failed to adequately plead why making such a demand would have been futile), the Court dismissed the complaint asking the defendant director to reimburse the expenses incurred in defending/settling the reclassification. Ergo, what happened is that said expenses were ultimately borne by shareholders, the same ones that would have been harmed by the reclassification itself!

That is not to say that the reclassification was unfair/detrimental per se and that the directors approved it in bad faith. The point is that, by lacking the aforementioned "safety valve,"[216] the new test did

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[210] *See* Gail Weinstein et al., *Conflicted Controllers, the "800-Pound Gorillas": Part I – Tornetta*, HARV. L. SCH. F. ON CORP. GOV. (Nov. 2, 2019), available at https://corpgov.law.harvard.edu/2019/11/02/conflicted-controllers-the-800-pound-gorillas-part-i-tornetta/ ("The court emphasized in this case the potential for coercive influence by controllers – 800-pound gorillas – over directors (who the controller typically can remove or not reappoint) and unaffiliated stockholders (who the controller can harm through retributive acts such as a squeeze-out merger or the cutting of dividends.").

[211] *See* Tornetta v. Musk, *supra* note 209, at 7-8.

[212] Lawrence A. Hamermesh et al., *Optimizing the World's Leading Corporate Law: A 20-Year Retrospective and Look Ahead*, HARV. L. SCH. PROGRAM ON CORP. GOV., Discussion Paper No. 2021-12 (Oct.29, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3954998/ ("We respectfully submit, however, that this approach to Aronson ignores the continuing utility of Aronson's second prong as an integrity-enhancing safeguard.").

[213] *See supra* note 73 (about *Aronson*'s test).

[214] *See* Stephen M. Bainbridge, *supra* note 157; *see also supra* note 167 and accompanying text; *see also* United Food, *supra* note 149, at 16 ("The refined test refocuses the inquiry on the decision regarding the litigation demand, rather than the decision being challenged.").

[215] *Id*. at 17 ("It is no longer necessary to determine whether the *Aronson* or the *Rales* test governs a complaint's demand-futility allegations."); *see also* Stephen M. Bainbridge, *supra* note 157 ("The Supreme Court adopted the Court of Chancery's three-part test as the universal test for assessing whether demand should be excused as futile . . . because the three-part test is consistent with and enhances *Aronson*, *Rales*, and their progeny, the Court need not overrule *Aronson* to adopt this refined test, and cases properly construing *Aronson*, *Rales*, and their progeny remain good law.").

[216] *See* Lawrence A. Hamermesh et al., *supra* note 212 ("The safety valve function of *Aronson*'s second prong is missing. It doesn't account for structural bias.").

not even permit the (purportedly) aggrieved party to present its claims and to let the Court evaluate the case in its entirety, a case which has many dubious aspects that would deserve – at least – to be examined. Such function of Aronson's second prong, if properly applied, would permit a plaintiff to plead facts suggesting that, even if board members were technically found to be disinterested/independent and the procedures used were "facially adequate,"[217] there has been some sort of breach of fiduciary duty which caused a damage to the corporation.[218] The potential for structural bias described by Hamermesh is not accounted for by the new test, because, pertaining to the situation in which a majority of the demand board did approve the transaction in question,[219] it clearly clashes with the assumption underlying *Rales* (and, consequently, its implemented version).[220] According to former Chief Justice E. Norman Veasey (in the decision of *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*[221]), such a structural bias – stemming from cultural bond, empathy, collegiality and economic/psychological dependency to the corporation's executives[222] – is present where a non-interested director would be "more willing to risk his reputation than risk the relationship with the interested director,"[223] precisely as in our case.

[217] *See* Lawrence A. Hamermesh et al., *infra* note 218.
[218] *See* Lawrence A. Hamermesh et al., *supra* note 212, at 52 ("[D]espite the presence of a majority of independent disinterested directors and the use of facially adequate procedures, there was a fiduciary breach resulting in harm to the company.").
[219] *See* Stewart, *supra* note 193, at 1050-51 ("[A] structural bias argument which presupposes that the professional and social relationships that naturally develop among members of a board impede independent decisionmaking."); *see also* Aronson v. Lewis, *supra* note 57, at 815 ("[T]he structural bias common to corporate boards throughout America, as well as other unseen socialization processes cutting against independent discussion and decisionmaking in the boardroom.").
[220] *See* Lawrence A. Hamermesh et al., *supra* note 212, at 52 ("This safety valve exists precisely because of the potential for structural bias where, contrary to the assumption underlying *Rales*, a majority of the demand board approved the business decision under attack in the derivative action.").
[221] *See* Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, *supra* note 193.
[222] *See* Julian Velasco, *supra* note 82 ("[T]he result of the common cultural bond and natural empathy and collegiality shared by most directors, the economic or psychological dependency upon or ties to the corporation's executives, particularly its chief executive, and the process of director selection and socialization, which incumbent management dominates.").
[223] *Id.*

IV. CONCLUSION

In the end, what happened is that the Delaware Supreme Court has probably utilized this apparent preference of form over function as a vehicle to underline – once again – its plainly pro-director stance. Exactly as *Smith v. Gorkom* meant the opposite,[224] *United Food* signals the latest step in Delaware's race-to-the-bottom,[225] going towards director discretion and against judicial interference. Let's not forget that the null hypothesis is always that the board shall have the last word.[226] Sidestepping its members (by initiating a derivative action and avoiding to make a litigation demand) corresponds to trumping that same authority which investors thought to grant them in the first place. Even though accountability remains the necessary flipside of authority – ensuring that director do not exploit their discretion for interests diverse than those of the corporation – judicial intervention to enforce fiduciary duties has to emerge intermittently,[227] in order to preserve the value of authority which is so precious for the corporate form.

Even though the new universal test set out in *United Food*, like its antecedent *Rales*, directly gets to the core of the futility inquiry (namely the question whether the board could impartially consider a demand), it could look like the very case it was designed to address in the end slipped from its net. There may have been a (potential) breach of fiduciary duty by the directors in approving a transaction (the reclassification) which was not plainly[228] in the corporation's best interests. At the very least, the Court should have allowed the plaintiff to let his claims be examined, especially in such a dubious situation like one including a controlling shareholder on both sides of the deal. But, by strictly adhering to the concepts of "independent" and "disinterested," the members of the board were found to be able to impartially consider a demand, had it been made by Tri-State. Moreover, by losing the so-called "safety-valve function" of *Aronson*'s second prong, the test lacked (and, to date, lacks) a way to put structural bias into the equation: a board composed of facially independent directors may nonetheless miss the impartiality necessary to decide whether to redress the harm suffered by the corporation, for example – as in this case – where its members breached their fiduciary duties in approving themselves the transaction having caused such a harm. That is, an example of giving priority to the form (i.e. a strict application of the materiality standard) vis-à-vis its function, namely finding out whether there has been a breach of fiduciary duty in the first place.[229]

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[224] *See* Bernard S. Sharfman, *supra* note 177 (about *Van Gorkom* being an exaggeration on the side of accountability).
[225] *See* Pierluigi Matera, *supra* note 151 (about Delaware's plainly pro-director stance in adopting laws favoring management).
[226] *See* Aronson v. Lewis, *supra* note 57, at 811 ("A cardinal precept of Delaware law is that directors, rather than shareholders, manage the business and affairs of the corporation."); *see also supra* note 12 and accompanying text (about DGCL § 141(a) – delegation of power).
[227] *See* Bernard S. Sharfman, *supra* note 172, at 308 ("[T]he central problem of corporate law is ensuring that fiduciary duties are applied intermittently so that they do not jeopardize the value of centralized authority that statutory corporate law was structured to protect.").
[228] *In re* Trulia, Inc. Stockholder Litigation, 129 A.3d at 899 (Del. Ch. 2016) ("Plainly . . . implies that it should not be a close call . . . .").
[229] *See* Lawrence A. Hamermesh, *supra* notes 212, 216, 218 & 220 and accompanying text (about Aronson's "safety-valve" function in taking structural bias into account).

In the end, it will probably do fine in the future. The new standard applies principles which, in the end, are not so unlike the previous ones.[230] The test in fact is more than similar to the original one, maybe technically more refined, due to the inclusion, in the second prong,[231] of a reference to the necessity for the plaintiff to plead a non-exculpated claim,[232] in order for his suit to be allowed to go forward (i.e. for the demand to be excused as futile). The common lesson is that to be able to establish that a demand on the board should be excused as futile, the hurdles to be overcome are significant.

The Court's decision to dismiss Tri-State's claim was probably just a coincidence or an exercise of rigor: there are rules, and they have to be followed, although, as emerged in multiple occasions,[233] in applying standards courts should always be careful to adequately take into account the policy purposes those standards were intended to achieve,[234] otherwise risking distortions like those caused by *Smith v. Van Gorkom*[235] or the Sarbanes-Oxley Act of 2002.[236] Nevertheless, there are cases in which form did indeed triumph over function (for example, de facto mergers vs the different acquisition techniques[237]), and this may just be the latest.

Maybe it's another case like *Tornetta v. Musk*, where the Court, albeit in the presence of a conflicted interest transaction, decided to defer to the 800-pound gorilla's authority and to turn a blind eye to Musk's self-compensation scheme.[238] Or maybe: Delaware is famous for being the least friendly jurisdiction for external constituencies (it's one of the few states not having adopted a constituency statute[239]), and the court could have possibly pursued the ultimate objective of keeping shareholders' interests in first place vis-à-vis external stakeholders (i.e. whom the Giving Pledge and the reclassification would have benefitted).

Or maybe it's just a way for Delaware to remind us not to meddle with directors: they will always have the last word in Delaware corporations.

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[230] *See* Tariq Mundiya et al., *Delaware Supreme Court Adopts Unified Demand Futility Test*, WILLKIE FARR & GALLAGHER LLP (Sep. 27, 2021), *available at* https://www.willkie.com/-/media/files/publications/2021/09/delawaresupremecourtadoptsunifieddemandfutilitytes.pdf/ ("The core principles considered by Delaware in assessing demand futility will remain unchanged after *Zuckerberg*.").

[231] *See supra* note 153 and accompanying text (about *United Food*'s second prong).

[232] *See* Cornerstone, *supra* note 169 and accompanying text (about the necessity of pleading a non-exculpated claim.").

[233] *E.g.* Surowitz v. Hilton Hotels Corporation, *supra* note 41 (although not complying with the verification requirement, the court decided that it wouldn't be equitable to blindly dismiss the claim).

[234] *See, e.g.*, William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1297 (2001) ("[B]ecause standards of review serve important policy functions, to formulate or apply those standards without being sufficiently mindful of those functions, risks creating unintended distortions of incentives to the detriment of stockholders.").

[235] *See* Bernard S. Sharfman, *supra* note 172 (about directors resigning from their positions after *Van Gorkom*).

[236] SARBANES-OXLEY ACT OF 2002 (15 U.S.C. § 7201), *available at* https://uscode.house.gov/view.xhtml?path=/prelim@title15/chapter98&edition=prelim; *see also* William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953 (2003) ("One likely consequence of the 2002 Reforms is a further diminution in the already shrinking ranks of management directors who serve on boards of public companies.").

[237] *See* STEPHEN M. BAINBRIDGE, *supra* note 2, at 423 ("[F]orm was to be elevated over substance. The de facto merger offended the equal dignity of the merger and asset sale provisions of the corporation code. Put another way, the legislature has provided multiple vehicles by which to achieve the same substantive outcome . . . and the court could not gainsay the legislative decisions to provide different acquisition forms carrying different levels of shareholder protection . . . .").

[238] *See supra* notes 209 & 210 and accompanying text (about Elon Musk, the 800-pound gorilla).

[239] *See* Jitendra Aswani et al., *supra* notes 180 & 181 (about Delaware not having adopted a constituency statute).

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