Notes on Derivative Litigation October 19, 2023

Caroline Bradley[*]

In 2021 the Delaware Supreme Court issued judgments in two cases that significantly alter how we think about issues in derivative litigation: Brookfield Asset Management v Rosson (dealing with the distinction between direct and derivative claims) and United Food and Commercial Workers Union v. Zuckerberg (dealing with the demand requirement).

We have noticed already that shareholders may bring claims as direct claims or derivative claims. Derivative claims are claims brought on beghalf of the corporation which has allegedly suffered harm, and whereas directors generally have the power to control the management of the corporation (e.g., DGCL §141), which includes the power to make decisions about litigation, in some circumstances shareholders are allowed to pursue a derivative suit. However, the general rule about initiating a derivative suit is that the shareholder should make a demand on the Board, unless demand is not required because it would be futile (we saw this idea in Stone v Ritter). In addition a corporation may take back control of the litigation by establishing a special litigation committee to assess whether the litigation is in the corporation's interests. If the committee is established appropriately (members are independent), and the committee adopts sound processes to make the decision about whether the litigation may proceed, the court may decide the corporation can take over control of the litigation (and this usually means to end it).

Because of these constraints on derivative litigation, where possible it may make sense to bring claims as direct claims. Smith v Van Gorkom was brought as a shareholder class action to recover additional consideration for the Transunion shareholders. Where a corporation is facing a change of control, directors and officers are subject to "Revlon duties"[1] and courts will apply "enhanced scrutiny" to their actions, rather than applying the business judgment standard of review. Where Revlon duties apply, the directors and officers are required to ensure they obtain the highest value for shareholders, and this is a duty owed to the shareholders directly. They are not required to negotiate merely because they receive an offer to acquire the company, but they apply where the company embarks on a transaction.

Direct and Derivative Claims

Here are some examples of derivative suits from the cases we studied earlier: Kamin v Amex (dividend policy rather than a shareholder's claim to be entitled to dividends), Shlensky v Wrigley, Walt Disney, Stone v Ritter.

[*] Professor of Law, University of Miami School of Law, PO Box 248087, Coral Gables, FL, 33124, cbradley@law.miami.edu. © Caroline Bradley 2023. All rights reserved.

[1]Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

A corporate opportunities case would be a derivative claim if brought by a shareholder, but whereas E-bay is a derivative claim, Broz is a case brought after a change in control of the corporate decision-making process (Pricellular acquisition, change in board composition).

Smith v Van Gorkom (transactions in corporate control unfairly affecting the plaintiff shareholder where directors have a duty to shareholders) is an example of a direct claim by shareholders. The directors' duty to ensure the highest price reasonably obtainable for the shares is a duty owed to the shareholders.

Some issues (think, for example about Caremark-type situations) can be analyzed either as breaches of directors' duties (derivative) or as securities claims, focusing on failures with respect to disclosure (direct). We will look at disclosure issues later.

Before Brookfield Asset Management I would have told you that dilution claims (e.g. think Benihana) could be stated as direct claims.

I am going to ask you to read Brookfield Asset Management v Rosson, but here are some notes on the case to help you navigate it. Plaintiffs, former stockholders of Terraform Power Inc. challenged a 2018 private placement of shares in the company to Brookfield Asset Management (and affiliated entities) for allegedly inadequate consideration. The private placement was to fund an acquisition Terraform decided to make.

Brookfield was a controlling stockholder of Terraform as of October 2017, with 51% of the class A stock and the right to appoint the CEO, CFO and General Counsel, and 4 of the 7 directors. The other 3 directors constituted the Conflicts Committee which would approve material transactions in which Brookfield was interested.

The original plan for financing the acquisition was a public equity offering with a Brookfield backstop, but this idea was converted to a private placement to Brookfield with limited consideration by the Conflicts Committee. Terraform shares subsequently increased in value above the placement price.

The complaint stated direct and derivative claims for inadequate value, diluting the financial and voting interest of minority shareholders and harm to the company. After the filing of the complaint a Brookfield affiliate proposed to acquire all of Terraform's public shares and this transaction was subsequently completed (extinguishing the former shareholders' rights to maintain a derivative suit).

An earlier precedent in Gentile v Rossette suggested that overpayment cases involving dilution claims could be stated as direct claims. Brookfield Asset Management v Rosson overrules Gentile v Rossette (where the Court said "the harm to the minority plaintiffs "resulted from a breach of a fiduciary duty owed to them by the controlling shareholder, namely, not to cause the corporation to effect a transaction that would benefit the fiduciary at the expense of the minority shareholders.")

The Court states that, although claims for harm to the corporation are derivative: "[a] stockholder who is directly injured retains the right to bring an individual action for injuries affecting his or her legal rights as a stockholder."

The Court says that Tooley states the test: who suffered the harm, and who would receive the benefit of any recovery?

Under Brookfield Asset Management, overpayment claims are derivative claims: "the gravamen of the Complaint is that the Private Placement was unfair and that TerraForm suffered harm." This is based on language in Tooley that for a direct claim a stockholder must show breach of a duty to the stockholder and must be able to prevail without showing injury to the corporation.

With respect to the overpayment idea (shares being issued to Brookfield for inadequate consideration), the court states: "The alleged economic dilution in the value of the corporation's stock is the unavoidable result of the reduction in the value of the entire corporate entity, of which each share of equity represents an equal fraction. Dilution is a typical result of a corporation's raising funds through the issuance of additional new shares."
In a footnote the court states: "In such cases, the remedy could be cancelling the shares and allowing the corporation to sell them for fair value or requiring the acquirer to pay fair value for the shares."

And: "To the extent the corporation's issuance of equity does not result in a shift in control from a diversified group of public equity holders to a controlling interest, (a circumstance where our law, e.g., Revlon, already provides for a direct claim), holding Plaintiffs' claims to be exclusively derivative under Tooley is logical and re-establishes a consistent rule that equity overpayment/dilution claims, absent more, are exclusively derivative."

Gentile v Rossette is overruled because of the tension with Tooley: under that case the stockholder's injury must be independent of any injury to the corporation. In addition, Gentile blurred Tooley's clear rejection of the "special injury" test. Gentile focused on the wrongdoer (controlling shareholder who owes duties to minority shareholders and the corporation) and this deviates from Tooley's focus on 2 central inquiries as to who suffered the harm and who gets the benefit of any remedy. And :"[t]he difficulty courts have had in applying Gentile in a logically consistent way, along with Gentile's erosion of Tooley's simple analysis convinces us that Gentile should be overruled."

There are some problems with the case. In order for a shareholder to bring a derivative claim, the shareholder must have held shares in the corporation at the time of the acts complained of, at the time the suit is filed, and throughout the litigation. A former shareholder does not have standing to bring a derivative suit. The determination that dilution claims must be brought as derivative claims means that there will be situations where there is no recourse for former shareholders.

The decision means that in cases where a controlling shareholder engages in dilution, the claims are derivative. However, a shareholder in a corporation with no controlling shareholder,

where directors sell enough shares to create a controlling shareholder (Revlon applies) has a direct claim (Revlon applies to a range of circumstances including sales or changes of control). Note the problem with identifying what constitutes control.

To sum up:

- Claims that focus on rights of shareholders, such as rights to vote, contractual rights of shareholders, involve direct claims.
- Where directors owe duties to shareholders, rather than to the corporation, the shareholders' claims are direct (e.g. Smith v Van Gorkom).
- Where shareholders have claims under a statute (e.g. claims for securities fraud) they may bring those claims as direct claims.
- Claims that directors breached duties to the corporation are derivative claims.
- If losses the shareholders complain of are merely reflections of loss to the corporation, any claims will be derivative. Brookfield Asset Management says dilution claims are in this category. [cf. Fairholme Funds v US, Fed. Cir 2022: overpayment claims generally derivative.]

The Demand Requirement: United Food and Commercial Workers Union v Zuckerberg (Del 2021)

Plaintiff shareholders commenced a derivative suit, without making demand, relating to a share reclassification plan, approved with Zuckerberg voting in the stockholder meeting, that would have allowed Zuckerberg to sell most of his FaceBook (as it then was, FB) shares while retaining voting control of FB. The plan was withdrawn after it gave rise to litigation in circumstances where FB paid more than $88 m in legal expenses.

FB moved to dismiss on the basis that there was no demand and the complaint did not establish demand was futile under Aronson v Lewis.

The Delaware Supreme Court adopts a new 3 part test for demand futility partly because of DGCL §102(b)(7), partly because Aronson is sometimes difficult to apply. The idea that demand could be excused where the underlying transaction was not the product of sound business judgment is not really helpful.

Cases properly applying Aronson, Rales and their progeny remain good law. The court articulates a refined test for demand excusal: "the refined test "refocuses the inquiry on the decision regarding the litigation demand, rather than the decision being challenged."

The decision sets out a new three-part test applied on a director-by-director basis to determine whether demand should be excused as futile:

(i) whether the director received a material personal benefit from the alleged misconduct that is the subject of the litigation demand;
(ii) whether the director would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand; and
(iii) whether the director lacks independence from someone who received a material personal benefit from the alleged misconduct that is the subject of the litigation demand or who would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand.

If the answer to any of these questions is yes for at least half the members of the demand board

demand is excused as futile.

The Court states:

"The purpose of the demand futility analysis is to assess whether the board should be deprived of its decision-making authority because there is reason to doubt that the directors would be able to bring their impartial business judgment to bear on a litigation demand. That is a different consideration than whether the derivative claim is strong or weak because the challenged transaction is likely to pass or fail the applicable standard of review. It is helpful to keep those inquiries separate. And the Court of Chancery's three-part test is particularly helpful where, like here, board turnover and director abstention make it difficult to apply the Aronson test as written."

To show a lack of independence the plaintiff must plead particularized facts creating a reasonable doubt that the director is so beholden to an interested director that their discretion would be sterilized; ties must be material or substantial, and the court must draw all inferences in favour of the plaintiff on a motion to dismiss. Friendship may affect independence if it is of a bias-producing nature.

The court finds that the plaintiffs failed to plead sufficient alleged facts to establish a lack of independence on the part of enough board members to establish demand futility.

In particular, the idea that 2 of the directors (Hastings and Thiel) might have a bias in favour of founder control was not a basis for a lack of independence (e.g. "Hastings might have a good-faith belief that founder control maximizes a corporation's value over the long-haul. If so, that good-faith belief would play a valid role in Hasting's exercise of his impartial business judgment.")