Demand Futility Standards in the Executive Compensation Context

By Michael M. Farhang and Patrick Doust, Delaware Business Court Insider

On May 5, Andre G. Bouchard was sworn in as the Delaware Court of Chancery’s newest chancellor. Since taking the bench, Bouchard has authored two recent opinions exploring the standards for pleading demand futility in stockholder derivative cases. The results in these two cases were different—one decision granted a motion to dismiss for failure to plead demand futility and the other denied one—but the context of both cases was similar in that they involved claims relating to the award of compensation packages to corporate executives and directors, and explored the contours of the familiar Aronson demand-futility pleading standard. Both decisions are consistent in their careful application of longstanding precedent and sophisticated approach to the principles underlying director disinterestedness, independence and application of the business judgment rule.

Friedman v. Khosrowshahi

Friedman v. Khosrowshahi, 2014 Del. Ch. LEXIS 121 (July 16, 2014), the first of the two Court of Chancery decisions, granted a defense motion to dismiss based on failure to plead demand futility and reaffirmed the bedrock Delaware principle that a director is not deemed “interested” for purposes of the Aronson analysis simply because he or she might face liability for approving a transaction. In Friedman, the plaintiff claimed that the board of directors of Expedia breached its fiduciary duties by accelerating the vesting of restricted stock units (RSUs) awarded to Expedia’s CEO through impermissible waiver of one of the award’s vesting requirements in violation of Expedia’s stock and annual incentive plan. Pre-suit demand was not made on the Expedia board.

Invoking the first Aronson prong, the plaintiff, Julie Friedman, alleged a reasonable doubt as to director disinterestedness in evaluating a potential demand on the grounds that certain directors were directly involved in accelerating the RSU award. In addition, Friedman alleged that certain directors lacked independence because of their ties to at least one other implicated director. Regarding director independence, the court held that the allegations of previous business relationships were not sufficient to create a reasonable doubt as to the independence of certain directors at issue. As to disinterestedness, the court reinforced the holding in Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984), that a “mere threat” of liability was not sufficient to challenge director disinterestedness, and that “rather, the plaintiff must plead facts sufficient to show that approval of the transaction was so egregious on its face that ... a substantial likelihood of director liability exists.” In reviewing the documents governing and disclosing the RSU award, the court concluded that a reasonable interpretation favored the directors’ authority to waive the requirement in question without violating the plan. The court also noted that the plan allowed the compensation committee to resolve any ambiguity in the plan, and held that the existence of potential ambiguity in the RSU award’s terms undermined an inference that the directors had engaged in a knowing violation of the plan that could give rise to a substantial likelihood of liability.

With respect to the second Aronson prong, Bouchard disagreed with the proposition that the waiver decision was a clear
violation of the plan and thus not a valid exercise of business judgment, holding that the pleadings established that the compensation committee waived the requirement based on what could have been a reasonable construction of the RSU award, and that the potential ambiguity in the award’s terms did not give rise to an inference of a clear or intentional violation of the plan under the facts alleged. Although this determination was based on a legal interpretation of governing contracts and agreements, the court evaluated what was arguably a factual question (directors’ state of mind) and concluded that Friedman’s allegations failed to create the necessary inferences for demand futility. Friedman, therefore, reinforces that Aronson’s standard does not permit plaintiffs to rest on the mere proposition that directors are “interested” merely because they participated in a challenged transaction, and that demand futility pleadings require particularized allegations supporting an inference that such liability is substantially likely.

**Cambridge Retirement System v. Bosnjak**

In the second case, Cambridge Retirement System v. Bosnjak, 2014 Del. Ch. LEXIS 107 (June 26, 2014), the court denied a motion to dismiss based on failure to plead demand futility and in doing so, explored the concept of “self-dealing” as a basis for director interestedness. Cambridge involved derivative claims relating to director approvals of compensation paid to the directors themselves for their board service with Unilife, a company that the court noted had never shown a profit since its inception in 2002. According to the allegations, while Unilife’s revenues declined from $6.7 million to $2.7 million during 2011-13, Unilife’s outside directors awarded themselves close to 25 percent of the company’s annual revenues when setting their yearly compensation during the same period.

Engaging in a careful review of Court of Chancery precedent, Bouchard’s decision acknowledged the settled law that, for purposes of demand futility pleading, directors are deemed to be “interested” in decisions on their own compensation. The court also held that where allegations of self-dealing by directors are present, the compensation at issue need not be deemed “material” to create a reasonable doubt as to disinterestedness. Finally, the court rejected the argument that Section 141(h) of the Delaware General Corporation Law, which grants directors authority to fix director compensation, necessitates a more rigorous conjunctive—rather than disjunctive—Aronson standard for demand futility pleading where such compensation decisions are concerned. The court held that while Section 141(h) provided authority for such decisions, it did not govern the standard of review for such decisions.

The court’s opinion in Cambridge, which included a thoughtful consideration of prior case law, reinforces that allegations of demand futility will be met with greater receptivity where a director sits on both sides of a compensation decision that is the subject of litigation. While defense counsel put forth novel arguments to the contrary, the Cambridge decision provides a straightforward reading of Court of Chancery case law and the DGCL, clarifying that there is no materiality requirement for allegations of interestedness in the self-dealing context.

**Evaluating demand futility pleadings**

The two recent Court of Chancery decisions in Friedman and Cambridge reflect a careful and sophisticated approach to the application and contours of Aronson’s first and second prongs in evaluations of demand futility pleadings. In Friedman, the court was willing to grant a motion to dismiss by considering potential ambiguities in governing corporate documents as part of an evaluation of the reasonableness of directors’ actions for purposes of the Aronson first and second prongs. In addition, the court showed its deference to longstanding precedent in rejecting the notion that a director is deemed interested under the first Aronson prong simply because he or she may face potential liability, and applied a rigorous analysis to determine whether the “substantial likelihood” standard had been met. In Cambridge, the court denied a similar motion, engaging in a meticulous discussion of prior Court of Chancery precedent to address novel defense arguments about demand futility in the context of director compensation decisions, and making clear that director self-dealing remains a touchstone for analysis of allegations of interestedness in the demand futility context.

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