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Chancery Court Rejects Demand Futility in Absence of Particularized Allegations

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In *Steinberg v. Bearden*, C.A. No. 2017-0286-AGB (Del. Ch. May 30, 2018), the Delaware Chancery Court considered whether the *Aronson* or *Rales* test for demand futility should apply to a derivative claim for breach of fiduciary duty against directors who allegedly made false and misleading statements. After concluding that the plaintiff had failed to plead that a majority of the board had acted improperly, Chancellor Andre G. Bouchard applied *Rales* and granted defendants' motion to dismiss under Rule 23.1 for failure to make a demand on the board.

The plaintiff was an individual stockholder of Hortonworks Inc., an enterprise software firm. The plaintiff derivatively alleged that Hortonworks' seven directors, including the CEO, as well as its nondirector CFO, had breached their fiduciary duties in making four purportedly false or misleading statements about the sufficiency of the company's cash position. Two of the statements were identical and appeared in Hortonworks' Form 10-Q disclosures in the latter half of 2015. The other two—essentially that the company was "comfortable" with its cash position—supposedly were made by the company's CEO on earnings calls in November and December 2015. On Jan. 15, 2016, Hortonworks announced a secondary public offering to raise cash in the marketplace, and on "the first trading day after the announcement, the company's stock closed down 37 percent, falling from $16.57 per share to $10.44 per share."

On April 13, 2017, without making any demand on the board, the plaintiff commenced her derivative action and asserted three claims on behalf of Hortonworks: breach of fiduciary duty, indemnification and contribution, and unjust enrichment. At bottom, plaintiff alleged that the four statements at issue from the second half of 2015 were misleading in light of August 2015 board resolutions authorizing preparations for a $130 million secondary public offering and the subsequent public offering. In addition, at the Aug. 20, 2015, board meeting, the CFO presented the reasons that the secondary offering should be pursued. Those reasons included "alleviating investor concerns of our need to have more cash on the balance sheet" and "CFO rulebook #1: 'always take the $ when you don't need it.'" The plaintiff claimed that the four statements were false and misleading because, among other things, they "omitted the fact the board approved the [secondary public offering] on Aug. 20, 2015, because the company needed more cash," and the CEO "knew the company needed more cash than it was generating going forward."

The defendants moved to dismiss for failure to make a pre-suit demand on the board and failure to state a claim. On May 30, 2018, Bouchard dismissed the suit in its entirety. As an initial matter, Bouchard analyzed which test should apply to decide whether the plaintiff's lack of demand was excused, which is the case when "the directors upon whom demand would be made 'are incapable of making an impartial decision regarding such litigation.'" He reasoned that the test from *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984), controls when "a decision of the board of directors is being challenged," and if a decision is approved by at least half of the directors, it can be imputed to the entire board. In contrast, the chancellor concluded that the test in *Rales v. Blasband*, 634 A.2d 927 (Del. 1993), applies when directors are sued for having failed to act or when a decision is not made by the entire board, but instead is "approved by a board committee consisting of less than half of the directors who would have considered a demand, had one been made."

Bouchard rejected the plaintiff's arguments and applied the *Rales* test because none of the disclosures at issue was the product of a single decision of the majority of the board. Importantly, the chancellor determined that the decision of the company's three-person audit committee to approve the quarterly financials was distinct from the CEO's decision to sign them.

Under the *Rales* test, a complaint must be dismissed "unless [its] particularized allegations 'create a reasonable doubt'" that a majority of "the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand." The plaintiff argued that test was met because "a majority of the board face[d] a substantial threat of personal liability with respect to her disclosure claims such that the board could not consider a demand impartially."

Bouchard found to the contrary. With respect to the CEO's statements, there were no particularized allegations that the other six directors were involved in making them or knew that they were false. As for the quarterly disclosures, there was no "particularized allegation that the members of the audit committee played any specific role concerning" the disclosures about the cash balance at issue. Nor did plaintiff's complaint adequately plead scienter with particularity. Nothing in the CFO's board presentation, "fairly read, could be said to demonstrate knowledge of falsity on the part of the audit committee members." Instead, the presentation evidenced a focus on stockholder concerns—not board concerns—about the company's cash position. Accordingly, Bouchard held that demand was not excused because the plaintiff had not shown that a majority of the board faced a substantial likelihood of liability. Bouchard thus dismissed the breach of fiduciary duty claim and the two contingent claims for contribution and unjust enrichment.

This decision helps illustrate the way that Delaware courts can view directors' involvement in corporate decisions for purposes of assessing demand futility, and, in particular, the circumstances under which courts may not attribute actions by certain directors to other directors.

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