If It Looks Like a Duck: Chancery Court Knows a Demand When It Sees One

By Brian M. Lutz and Jason H. Hilborn

The Delaware Court of Chancery recently held in Solak v. Welch, No. 2018-0810-KSJM (Del. Ch. Oct. 30, 2019), that a plaintiff’s letter to a board of directors suggesting the board look into its compensation system constituted a pre-suit demand. The decision reminds Delaware practitioners that if a letter looks like a demand, feels like a demand, and reads like a demand, it’s probably a demand—even if the stockholder plaintiff says otherwise.

Whether a letter to a board is a “demand” matters under Delaware law because it dictates the standard that applies in stockholder-derivative litigation that may arise out of the issues raised in the letter. If the letter is a “demand” letter, the stockholder plaintiff, by sending the letter, “tacitly concedes” that the board was able to properly consider the demand (quoting Spiegel v. Buntrock, 571 A.2d 767, 777 (Del. 1990)). If the board declines to take the action recommended in a demand letter, a stockholder plaintiff faces a difficult burden of demonstrating that the board “wrongfully refused” to take action in response to the demand, and therefore is not entitled to the protection of the business judgment rule. If, on the other hand, a letter to a board is not a “demand,” the stockholder plaintiff can satisfy the demand requirement by pleading particularized facts demonstrating that it would have been futile to make a demand before filing suit. Although pleading demand futility is not easy, it generally is a lower pleading burden than pleading facts demonstrating wrongful refusal.

Whether a pre-suit communication counts as a demand is a fact-intensive analysis. The standard test under Delaware law is whether the communication identifies: “the identity of the alleged wrongdoers, the wrongdoing they allegedly perpetrated and the resultant injury to the corporation, and the legal action the shareholder wants the board to take on the corporation’s behalf.” Only this last factor was at issue in Solak.

The stockholder plaintiff in Solak owned stock in a pharmaceutical company and sent a letter to the company’s board of directors. The letter had several notable features. Its expressed purpose was “to suggest that the [board] take corrective action to address excessive director compensation as well as compensation practices and policies pertaining to directors.” The letter included statistics on director compensation and claimed that the company’s director compensation exceeded the median compensation of directors at other companies

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identified in the letter. The letter also cited a Delaware Supreme Court case that reversed the Court of Chancery’s dismissing claims challenging director compensation. The letter asserted that the company’s compensation policy “lacks any meaningful limitations” and “warned” that “the company is more susceptible than ever to shareholder challenges unless it revises or amends its director compensation practices and policies.” The letter “suggested” that the board “take immediate remedial measures” and stated that the plaintiff “would consider ‘all available stockholder remedies’” if the board failed to respond within 30 days. Despite all this, the letter included a footnote saying that “nothing contained herein shall be construed as a pre-suit litigation demand under Delaware Chancery Rule 23.1,” and that “we do not seek or expect the board to initiate any legal action against its members.”

The board sent a response letter explaining that it viewed the stockholder letter as a demand, and declining to take any of the remedial actions suggested in the stockholder letter. So the stockholder sued, asserting the usual derivative claims for breach of fiduciary duty, unjust enrichment and waste.

At issue was whether the letter satisfied the third prong of the demand test: did the communication identify the legal action the stockholder wanted the board to take? The court explained that a pre-suit communication need not expressly demand litigation in order to be deemed a demand. Rather, the letter need only “clearly articulate the remedial action to be taken by the board” or “clearly demand corporate action.”

The letter “clearly articulated the need for ‘immediate remedial measures,’” suggested those measures, and asked the board to act on them. And it included “strong overtures of litigation” regarding director compensation. The letter also read like a complaint, sought relief that would benefit the company and its stockholders, and asked for common derivative-litigation remedies. For all these reasons, the court concluded, the letter was a demand. The footnote disclaimer that the letter was not a demand failed to rescue the letter from its fate because, the court concluded, the stockholder’s subjective intent is irrelevant. The analysis instead is objective and looks to whether the communication “would place a recipient ‘on notice of possible wrongdoing’” such that the recipient could take “corrective intracorporate action” (quoting Yaw v. Talley, (Del. Ch. Mar. 2. 1994)). Having held that the letter was a demand, the court dismissed the plaintiff’s complaint under the stringent demand-refused standard.

Solak serves as a reminder that the Court of Chancery is a court steeped not just in doctrine, but also common sense. As the Solak court noted—citing Vice Chancellor Sam Glasscock’s reference to “The Treachery of Images” by René Magritte—a painting of a pipe with the caption “this is not a pipe” still depicts a pipe. In other words, if something looks like a duck, walks like a duck, quacks like a duck, it’s probably a duck. The same is true for whether a pre-suit communication is a demand. The court will rely on the substance of the communication over any “tailored wordsmithing” of specific words and phrases, including disclaimers.

Boards of directors and their counsel also should use common sense in determining whether a pre-suit communication is a demand. If a stockholder letter puts a board on notice of alleged wrongdoing that the board could correct, a common-sense reaction should be that the letter is a demand and the board should treat it that way. If the board declines to act on the action recommended in such a letter, any challenge to that decision in a derivative case should subject the stockholder plaintiff to a heightened burden of pleading that the board wrongfully refused the demand. Common sense, Solak confirms, can go a long way for directors.

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