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Corporate and Securities Litigation

Demand Futility in Delaware Derivative Actions

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Delaware Chancery Court Rule 23.1 and its federal counterpart, Fed. R. Civ. P. 23.1, require a derivative complaint to allege, with particularity, plaintiff's efforts to obtain action from directors and the reasons for plaintiff's failure to obtain the action "or for not making the effort." Demand is required, unless futile, because "directors, rather than shareholders, manage the business and affairs of the corporation," and in a derivative suit, a stockholder seeks to displace the board's authority.[1] Thus, before divesting the board's authority, "the complaint must allege with particularity that the board was presented with a demand and refused it wrongfully or that the board could not properly consider a demand, thereby excusing the effort to make demand as futile."[2] The allegations must create "reasonable doubt" "the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand."[3]

Demand futility must be determined by the trial court on a "case-by-case basis" and "not by any rote or inelastic criteria."[4] Thus, application of these principles has often been confusing as trial courts have attempted to analyze particular fact patterns. Recently, however, courts have focused on the central concept that a substantial likelihood of personal liability compromises the directors' ability to consider a demand impartially.

Aronson and Rales Standards

In *Aronson v. Lewis* (note 1), the Delaware Supreme Court articulated disjunctive tests, applicable where a board decision is challenged and its composition has not changed. Under *Aronson*, a demand is futile if particularized allegations create either a "reasonable doubt" that "the directors are disinterested and independent," or a "reasonable doubt" that "the challenged transaction was otherwise the product of a valid exercise of business judgment." *Brehm v. Eisner* (note 4), 746 A.2d at 256, citing *Aronson*, 473 A.2d at 814, 816. In *Rales v. Blasband* (note 3), the Delaware Supreme Court established a broader singular standard to apply where the board which would consider the demand did not make an underlying business decision in the matter being challenged in the derivative suit. Under *Rales*, demand may be excused if plaintiffs allege "particularized facts establishing a reason to doubt that 'the board of directors could have properly exercised its independent and disinterested business judgment in response to a demand," *Wood v. Baum*, 953 A.2d 136, 140 (Del. 2008) (quoting *Rales*, 634 A.2d at 934). The Rales standard may be satisfied if allegations show a board remained consciously inactive when it knew or should have known about illegal conduct.[5]

Demand futility has recently been reviewed in a number of interesting related decisions in Delaware and in California applying Delaware law. *La. Mun. Pol. Emp. Ret. Sys. v. Pyott*, 46 A.3d 313 (Del. Ch. 2012), rev'd. on other grounds, 74 A.3d 612 (Del. 2013) and *Rosenbloom v. Pyott*, 2014 WL 4290625 (9th Cir. Sept. 2, 2014).

Allergan Derivative Litigation

The Allergan derivative litigation was commenced in September 2010 by the Louisiana Municipal Police Employees' Retirement System (LAMPERS) in the Delaware Chancery Court.[6] LAMPERS' complaint alleged breaches of duty by individual directors arising out of "Allergan's failed efforts (as demonstrated by the guilty plea and government settlement) to walk the fine line between off-label sales and off-label marketing."[7] Although physicians may prescribe a product for off-label use, and a manufacturer may sell a product notwithstanding off-label use, it is illegal for a manufacturer to market a drug for off-label use.

In October 2010, LAMPERS filed its first amended complaint in Delaware which Allergan and the director defendants moved to dismiss pursuant to Rule 23.1 and 12(b)(6). During the motion's pendency, U.F.C.W. Local 1776 & Participating Employers Pension Fund (UFCW), then a non-party, sent Allergan a section 220(b)[8] demand for books and records and, on Nov. 3, 2010, moved to intervene in the Delaware action. The Chancery Court denied the motion without prejudice, but postponed the dismissal motion hearing "until after the 220 process is over." Id. at 322. UFCW and LAMPERS filed a joint complaint in Delaware on July 8, and defendants moved to dismiss on July 15, 2011.

Meanwhile, similar derivative actions were filed in the Central District of California and subsequently consolidated. In April 2011, the California federal court dismissed the consolidated derivative actions, finding plaintiffs had not sufficiently alleged demand futility and rejecting plaintiffs' arguments that (1) the directors are liable under a Caremark oversight liability theory, (2) the directors were not disinterested and independent under Rales because of a substantial likelihood of personal liability, and (3) the directors could not exercise valid business judgment under *Aronson*.[9] The dismissal was without prejudice, and the California plaintiffs filed an amended complaint incorporating references to documents provided in response to the UFCW section 220 demand in Delaware which had been shared with the California plaintiffs. The California defendants again moved to dismiss.

Finding No Demand Futility

In January 2012, the California federal court, without oral argument, issued a five-page order dismissing the amended complaint with prejudice pursuant to Rule 23.1 for failure to plead demand futility (California Judgment).[10] The court found "[p]laintiffs have failed to allege any additional facts to warrant a different result under either the *Aronson* or *Rales* theory of liability," noting "[t]here is still no evidence of a decision by board members to promote the use of off-label marketing, nor are there any facts suggesting that the Directors would be incapable of making an impartial decision concerning litigation." Id at *3. With respect to the latter point, the court found "[t]he Director Defendants are thus disinterested under *Rales* because there is no evidence that they would be subject to substantial likelihood of liability" and "[t]here is also no evidence that they have broken the law or acted in any way that would be an invalid exercise of business judgment." Id. at *4.

Collateral Estoppel Issue

After entry of the California judgment, the Delaware defendants supplemented their motion to dismiss to invoke collateral estoppel, but Vice Chancellor J. Travis Laster, recognizing the California court had misapplied Delaware law, rejected that defense despite the constitutional mandate that "[f]ull faith and credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State"[11] and the statutory mandate[12] that full faith and credit be given to the same extent as given "by law or usage" in the courts of the state in which the judgment was entered.[13]

The vice chancellor ruled successive derivative plaintiffs are not in privity if the first, due to a successful Rule 23.1 motion, does not have the authority to sue on behalf of the corporation, thus precluding collateral estoppel. Id. at 3270328. Alternatively, he held the California plaintiffs did not conduct a meaningful investigation of Allergan's books and records before filing suit and, as a consequence, Allergan had been inadequately represented in the California federal action and, for that reason as well, collateral estoppel should not apply.[14]

Finding Demand Futility

Having ruled collateral estoppel inapplicable, the vice chancellor considered whether Rule 23.1 required dismissal. Explaining plaintiffs were entitled to reasonable factual inferences logically flowing from particularized allegations and need only make a "threshold showing" that their claims have some merit (Id. at 357), the vice chancellor concluded "a reasonable inference can be drawn…that the Board knowingly approved and subsequently oversaw a business plan that required illegal off-label marketing and support initiatives for Botox." Id. at 356.

Laster explained, "plaintiffs do not seek to impose liability on the Allergan directors for making a 'wrong' business decision or taking imprudent business risks" and "[c]orporate misconduct involving fraud or illegality presents a different situation." Id. at 351052. Indeed, "'[u]nder Delaware law, a fiduciary may not choose to manage an entity in an illegal fashion, even if the fiduciary believes that the illegal activity will result in profits for the entity.'"[15] And, "'[a]s a result, a fiduciary of a Delaware corporation cannot be loyal to a Delaware corporation by knowingly causing it to seek profits by violating the law.'" Id. at 352, quoting *Desimone v. Barrows*, 924 A.2d 908, 934035 (Del. Ch. 2007).

Recognizing he was "part[ing] company with the California Federal Court and find[ing] unpersuasive the analysis in the California Judgment," the vice chancellor stated, "a plaintiff does not have to point to actual confessions of illegality by defendant directors to survive a Rule 23.1 motion in a Caremark case." Id. at 357. In contrast to the California court, which found "[t]here is still no evidence of a decision by board members to promote the use of off-label marketing,"[16] the vice chancellor concluded, "there are sufficient references in the documents to support a reasonable inference that Allergan expected to drive increased sales by promoting off-label products" and "that directors in fact approved a business plan that contemplated off-label marketing." Id. at 357058. Thus, "[t]he plaintiffs in this case have alleged a direct connection between the Board and a business plan premised on illegal activity." Id. at 352.

Delaware Supreme Court

In April 2013, the Delaware Supreme Court reversed the vice chancellor not on the merits but on the threshold issue of collateral estoppel. Finding that Delaware law did not control the collateral estoppel determination, it held, under California law, that "derivative stockholders are in privity with each other because they act on behalf of the defendant corporation" and, with respect to adequacy of representation, the Chancery Court "adopted a presumption of inadequacy without any record to support the factual premise on which the presumption was based."[17]

The Supreme Court explained, the "motion to dismiss, based on collateral estoppel, was about federalism, comity, and finality," and "the undisputed interest that Delaware has in governing the internal affairs of its corporations must yield to the stronger national interests that all state and federal courts have in respecting each other's judgments." Id. at 616. With regard to inadequate representation, the Supreme Court rejected the "fast filer" presumption, acknowledging the Chancery Court's concerns, but explaining the remedies should be directed "at the lawyers, not the stockholder plaintiffs or their companies." Id. at 618.

Ninth Circuit Reverses

The California plaintiffs appealed dismissal of their derivative claims to the U.S. Court of Appeals for the Ninth Circuit. In an ironic twist, in September 2014, four years after the derivative litigation began, the Ninth Circuit reversed. *Rosenbloom*, at *16. The Ninth Circuit concluded the district court "misapplied governing Delaware law and improperly drew inferences against Plaintiffs rather than in their favor," and "Plaintiffs' particularized allegations establish a reasonable doubt as to whether the Board faces a substantial likelihood of liability and as to whether the Board is protected by the business judgment rule."[18] Id. at *1.

The Ninth Circuit reasoned, under *Aronson's* first test, "'[d]irectors who are sued have a disabling interest for pre-suit demand purposes when the potential for liability…may rise to a substantial likelihood.'" *Rosenbloom*, at *8, quoting *Ryan v. Gifford*, 918 A.2d 341, 355 (Del. Ch. 2007). And, under Aronson'ssecond test, in "rare cases" a transaction may be so egregious on its face that board approval cannot meet the business judgment test, but such "rare cases include those in which a board decides to undertake illegal activity."[19]

The Ninth Circuit observed that although the "applicable framework is less settled for claims that demand is excused on the ground that a board remained consciously inactive when it knew (or should have known) about illegal conduct," "[h]ere it does not matter whether *Aronson* or *Rales* applies" because "[u]nder either approach, demand is excused if Plaintiffs' particularized allegations create a reasonable doubt as to whether a majority of the board of directors faces a substantial likelihood of personal liability for breaching the duty of loyalty." Id.

Summary

Delaware law regarding demand futility is well-developed, but the Allergan derivative litigation demonstrates its application to a particular fact pattern may yield different results in different forums. Thus, plaintiff's counsel can seek a more friendly jurisdiction in which to litigate demand futility and Delaware will enforce that decision, right or wrong. Defense counsel and their clients should be alert to this possibility and seek to stay litigation in such jurisdiction in favor of Delaware where possible and appropriate.

Endnotes:

[1] *Aronson v. Lewis*, 473 A.2d 805, 811 (1984).

[2] *La. Mun. Pol. Emp. Ret. Sys. v. Pyott*, 46 A.3d 313, 339 (Del. Ch. 2012), rev'd on other grounds, 74 A.3d 612 (Del. 2013).

[3] *Rales v. Blasband*, 634 A.2d 927, 934 (Del. 1993).

[4] *Brehm v. Eisner*, 746 A.2d 244, 255 (Del. 2000).

[5] *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996).

[6] The filing came days after a Sept. 1, 2010, settlement between Allergan and the Department of Justice following an investigation of Allergan's off-label marketing practices relating, among other matters, to Botox Therapeutic, a drug widely known for its muscle-relaxing properties. Under the terms of the settlement, Allergan agreed to plead guilty to a criminal misdemeanor and pay fines aggregating $600 million.

[7] *La. Mun. Pol. Emp. Ret. Sys. v. Pyott*, 46 A.3d at 318.

[8] Section 220(b) of the Delaware General Corporation Law, Del. C. §220(b), gives any shareholder making a written demand under oath stating the purpose thereof the right to inspect a corporation's books and records.

[9] *In re Allergan, Inc. Shareholders Der. Litig.*, 2011 WL 1429626 (C.D. Cal. April 12, 2011).

[10] *In re Allergan, Inc. Shareholder Derivative Litigation*, 2012 WL 137457 (C.D. Cal. Jan. 17, 2012).

[11] U.S. Const., art. IV, §1.

[12] 28 U.S.C. §1738.

[13] This rejection was all the more remarkable in light of clear California precedent that the dismissal with prejudice by a California court of a derivative action bars a second derivative action by a different shareholder. See *LeBoyer v. Greenspan*, 2007 WL 4287646 (C.D. Cal. June 13, 2007). Instead of applying LeBoyer, the vice chancellor reasoned that the necessary privity between the plaintiffs should be determined under Delaware's internal affairs doctrine. The vice chancellor explained: "To my mind, whether a stockholder in a Delaware corporation can sue derivatively after another stockholder attempted to plead demand futility should not be governed by potentially different rules across twelve federal circuits, fifty states, and the District of Columbia, Puerto Rico and other territories. Applying different rules in different courts would disrupt the internal affairs of corporation." *La. Mun. Pol. Emp. Ret. Sys. v. Pyott*, 46 A.3d at 325027.

[14] Ironically, the vice chancellor adopted a "fast0filer presumption," i.e., a stockholder with a nominal stake who files an indemnification0based derivative action quickly after the announcement of a corporate trauma, without conducting a meaningful investigation, should be presumed to have not provided adequate representation, even though the Delaware action was filed before the California federal action.

[15] Id. at 352, quoting *Metro Commc'n Corp. v. Advanced Mobilecomm Techs*, 854 A.2d 121, 163064 (Del. Ch. 2004).

[16] *In re Allergan, Inc. Shareholder Der. Litig*. at *4.

[17] *Pyott v. La. Mun. Pol. Emp. Ret. Sys.*, 74 A.3d 612, 614 (Del. 2013).

[18] As a further irony, the Ninth Circuit relied, in part, on Vice Chancellor Laster's "lengthy and thorough analysis of how Delaware law applies to the issue of demand futility, noting that the vice chancellor "expressly criticized and rejected the district court's reasoning." Id. at *2.

[19] *Rosenbloom*, at *8, citing *In re Massey Energy Co.*, 2011 WL 2176479 at *20 (Del. Ch. May 31, 2011) ("Delaware law does not charter law breakersF.[A] fiduciary of a Delaware corporation cannot be loyal to a Delaware corporation by knowingly causing it to seek profit by violating the law.")