

CLIENT ALERT

# Delaware Supreme Court Adopts Unified Demand Futility Test

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For nearly two decades, the question of whether a formal demand on a company's board of directors was required before a stockholder could pursue derivative litigation on behalf of a corporation was governed by two tests under Delaware law. Where the derivative claims challenged an affirmative decision by the board of directors who would consider the demand, the two-part test under *Aronson v. Lewis*<sup>1</sup> applied. In all other contexts, courts would apply the test articulated in *Rales v. Blasband*.<sup>2</sup> On September 23, 2021, in *United Food and Commercial Workers Union v. Zuckerberg*, the Delaware Supreme Court affirmed and adopted the approach taken by the Court of Chancery in the proceedings below that unified the two tests into a single three-pronged inquiry.<sup>3</sup> In doing so, the Delaware Supreme Court acknowledged that significant changes in Delaware law since *Aronson* was decided had "eroded the ground upon which [the *Aronson*] framework rested" and, as a result, justified refining the test to "refocus" the inquiry "on the decision regarding the litigation demand, rather than the decision being challenged." Although the Delaware Supreme Court expressly noted that *Aronson*, *Rales* (and subsequent cases that applied them) were not being overruled, its adoption of the new unified test will streamline the analytical framework applicable to the often-litigated question of whether pre-suit demand on the board should be excused as futile.

<sup>1</sup> 473 A.2d 805 (Del. 1984), *overruled on other grounds*, 746 A.2d 244 (Del. 2000).

<sup>2</sup> 634 A.2d 927 (Del. 1993).

<sup>3</sup> *United Food and Commercial Workers Union v. Zuckerberg*, C.A. No. 404, 2020 (Del. 2021). Our summary of the Court of Chancery's decision below is available [here](#).

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### The Existing Framework for Assessing Demand Futility Under Delaware Law

Under Court of Chancery Rule 23.1, a stockholder seeking to assert derivative claims on behalf of a corporation must plead particularized facts showing either that (1) the stockholder has made a demand on the board of directors to pursue the litigation and the board wrongfully refused the demand; or (2) making a demand would have been futile because a majority of the board could not impartially make a decision regarding the litigation. Until the Delaware Supreme Court's opinion in *Zuckerberg*, there were two tests under Delaware law used to determine whether a stockholder had adequately pleaded demand futility. Under the *Aronson* test, which applied where the stockholder sought to challenge a decision by the same board that would consider the demand, the complaint had to plead facts creating a "reasonable doubt" that (1) the directors are disinterested and independent or (2) the challenged transaction was otherwise the product of a valid exercise of business judgment. In *Rales*, the Delaware Supreme Court developed a different test to apply in circumstances where the derivative litigation did not seek to challenge an affirmative board decision or when a majority of the directors on the board that would consider the stockholder litigation demand had not participated in the challenged decision. The test in *Rales* required a stockholder plaintiff to plead facts creating a "reasonable doubt" that, as of the time the complaint was filed, "the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand."

### The Court of Chancery Decision in *Zuckerberg*

In *Zuckerberg*, stockholders claimed that Facebook's board of directors breached its fiduciary duties by approving and pursuing a reclassification of Facebook's shares that would have enabled founder Mark Zuckerberg to retain voting control of the company despite donating a significant portion of his shares to charity. The reclassification was withdrawn and never went into effect, but the stockholders pursued damages for the money spent defending and settling the challenge to the reclassification.<sup>4</sup> Vice Chancellor Laster acknowledged that the *Aronson* test could apply because the challenged decision was an affirmative board action, but he nevertheless declined to apply *Aronson*. The Court of Chancery observed that there were several obstacles to the straightforward application of *Aronson*, including intervening developments in Delaware law, such as the enactment of Section 102(b)(7) of the Delaware General Corporation Law in 1995, which authorized Delaware corporations to add charter provisions exculpating directors for breaches of the duty of care. The Court of Chancery also noted practical difficulties applying the *Aronson* test in cases where directors abstained or joined the board after the challenged board decision.

In light of these obstacles to the straightforward application of *Aronson*, the Court of Chancery introduced a unified three-part test (discussed below) that applied the more flexible *Rales* test, while still drawing upon the principles that animated

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<sup>4</sup> *United Food & Commercial Workers Union v. Zuckerberg*, 250 A.3d 862, 891 (Del. Ch. 2020).

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*Aronson*.<sup>5</sup> Applying the unified test, the Court concluded that the plaintiff failed to establish that demand would be futile because six of Facebook's nine directors were able to exercise independent and disinterested business judgment to consider a demand.

### The Delaware Supreme Court Decision in *Zuckerberg*

The Delaware Supreme Court affirmed the Court of Chancery's decision in its entirety. In doing so, the Delaware Supreme Court affirmed the Court of Chancery's holdings that exculpated claims for breaches of the duty of care do not excuse demand under *Aronson*'s second prong<sup>6</sup> and that demand is not automatically futile when a transaction is subject to entire fairness review.<sup>7</sup>

Most important for practitioners, however, is that the Delaware Supreme Court expressly adopted the Court of Chancery's new, three-part test for demand futility.<sup>8</sup> The Delaware Supreme Court held that, going forward, courts and litigants must assess the following three questions on a "director-by-director basis when evaluating allegations of demand futility" with respect to each of the directors on the board at the time the complaint was filed (which it termed the "Demand Board"):

- (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 faces a substantial likelihood of liability on any of the claims that would be 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 would be 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.<sup>9</sup>

"If the answer to any of the questions is 'yes' for at least half" of the members of the Demand Board, "then demand is excused as futile."<sup>10</sup> Though it declined to overrule *Aronson* and noted that "cases properly construing *Aronson*, *Rales*,

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<sup>5</sup> 250 A.3d at 886 ("Viewed on its own terms, *Aronson* is no longer a functional test. Delaware decisions have managed to continue applying it only by emphasizing the overarching question of a substantial likelihood of liability, incorporating the implications of exculpation, and de-emphasizing the role of the standard of review. The foundational premise of the decision, which relied on the standard of review for the challenged decision as a proxy for whether directors face a substantial likelihood of liability, no longer endures.").

<sup>6</sup> *Zuckerberg*, C.A. No. 404, 2020, at 23–32.

<sup>7</sup> *Id.* at 33–34.

<sup>8</sup> *Id.* at 37–41.

<sup>9</sup> *Id.* at 41.

<sup>10</sup> *Id.*

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and their progeny remain good law,” the Delaware Supreme Court emphasized that it is “no longer necessary to determine whether the *Aronson* test or the *Rales* test” applies.

### Implications of *Zuckerberg*

By adopting the streamlined, unified test, *Zuckerberg*'s immediate impact will be to simplify litigation over the threshold question of demand futility in the many derivative lawsuits filed against Delaware corporations each year in state and federal courts across the country. Practically, *Zuckerberg* may be most impactful in cases formerly governed by the *Aronson* test and may foreclose arguments previously available to plaintiffs seeking to meet the rigorous pleading standards for establishing demand futility. In particular, *Zuckerberg* clarifies the rule that demand will not automatically be deemed futile if the challenged transaction is subject to a heightened standard of review. Because the Delaware Supreme Court expressly held that *Aronson*, *Rales*, and cases interpreting the older tests are still good law, however, practitioners can expect that the core principles considered by Delaware courts in assessing demand futility will remain unchanged after *Zuckerberg*. Overall, the Delaware Supreme Court's decision re-affirms the significant hurdles a stockholder must overcome at the pleadings stage to establish that demand on the board of directors of a Delaware corporation should be excused as futile.

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