Court of Chancery Addresses Fundamental Issues of Derivative Litigation

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These opinions provide helpful guidance to corporate law practitioners on fundamental issues of derivative litigation and reinforce the willingness of the Delaware Court of Chancery to continue to refine its approach to claims where a stockholder seeks to stand in the shoes of a corporation. It remains to be seen whether other members of the court will apply the new lines of reasoning discussed above, or whether the Delaware Supreme Court will ultimately weigh in to resolve any lingering uncertainty over dual-natured claims and the proper scope of the *Aronson* and *Rales* test for demand futility.

The Delaware Court of Chancery recently issued a trio of notable opinions involving stockholder derivative actions. The opinions addressed fundamental issues of law such as whether particular kinds of stockholder claims are derivative (or may be brought directly by a stockholder), the appropriate test for determining whether a presuit demand that the board bring claims on behalf of the company would have been futile (*i.e.*, demand futility) and the tension between such a demand futility analysis and the relevant standard of review.

In re El Paso Pipeline Partners, L.P. Derivative Litigation

In December 2015, the court issued an opinion finding that a derivative claim brought on behalf of an entity that had merged out of existence would thereafter be treated as a claim brought directly by the plaintiff. In characterizing the claim as direct rather than derivative, the court permitted the plaintiff to pursue the claim and a pro rata recovery of a $171 million damages award.

Earlier in the case, the court had ruled that the general partner of El Paso Pipeline Partners, L.P. (EP MLP) was liable for $171 million in damages on claims brought derivatively by a unitholder. EP MLP was set up to buy assets from a parent company and to use those assets to distribute cash flows to unitholders. The partnership agreement of EP MLP established a process of “Special Approval” for these transactions, which required a three-member committee from the general partner’s board to believe in good faith that the transaction was in the best interests of EP MLP. The court concluded after trial that the committee failed to do its job because it did not subjectively believe that EP MLP’s purchase of a 49 percent interest in a pipeline business and a 15 percent interest in another company were in the best interests of the partnership.

EP MLP subsequently merged into a related party and ceased to exist. The general partners then moved to dismiss the plaintiff’s derivative claim, arguing that the plaintiff did not have standing to continue to pursue claims on behalf of a nonexistent entity. In resolving that motion, the court characterized the claim as “dual-natured,” stating that “the plaintiff should be able to continue to litigate a dual-natured cause of action post-merger as a direct claim.” A claim is dual-natured in this context when it could be characterized as both a derivative and direct claim. Recognizing the potential for a future controversy over dual-natured claims, the court noted that although the Delaware Supreme Court has recognized dual-natured direct/derivative claims, there are “other decisions that have characterized similar claims as purely derivative.” The court ultimately determined that claims with direct and derivative features should be characterized as derivative at the outset of a case. But after a plaintiff demonstrates that a demand on the board was wrongfully denied or would have been futile and survives a Rule 23.1 motion to dismiss, such claims could be characterized as direct later in the case if the entity is merged out of existence. The court reasoned that treating a claim as “derivative for purposes of claim initiation achieves the important goals of screening out weak claims” while treating the “claim as direct for purposes of claim continuation preserves the ability of investors to pursue legitimate claims, promotes accountability, and provides a superior mechanism for doing so than secondary litigation challenging the transaction that eliminated the plaintiff’s standing to sue derivatively.” The court’s dual-natured characterization of direct/derivative claims provides more flexibility to plaintiffs bringing suits involving harm to an entity by limiting a plaintiff’s reliance on the continued existence of the entity.

In re EZCORP Inc. Consulting Agreement Derivative Litigation

A month later, in January 2016, the court issued an opinion granting in part and denying in part the defendants' motions to dismiss derivative claims for breach of fiduciary duty challenging certain consulting agreements. Of particular importance is the court's analysis of the applicable standard of review for a transaction's approval when a controlling stockholder has interests in both parties to a potential transaction or "stands on both sides" of a deal.

In this case, a stockholder of EZCORP brought a derivative action challenging the fairness of three annual consulting agreements between EZCORP and Madison Park LLC, an affiliate of EZCORP's controlling stockholder. The consulting agreements provided Madison Park with annually increasing fees in exchange for advisory services. The plaintiff argued that those agreements constituted self-dealing on behalf of the controlling stockholder and that the audit committee of EZCORP breached its fiduciary duties by rubber-stamping the agreements.

The court applied the heightened entire fairness standard of review, which requires a defendant to prove both fair price and fair process for a challenged transaction, and denied the defendants' motions to dismiss in part. The court observed that Delaware law is not settled on the applicable standard of review for a related-party transaction involving a controlling stockholder. In selecting the entire fairness standard of review rather than the deferential business judgment rule, the court relied on historical precedent and distinguished certain other Court of Chancery cases that had applied business judgment review to similar transactions. In *Friedman v. Dolan*, for example, the court applied the business judgment rule to a board's decision to pay compensation to a company's founder and his son, who controlled 73 percent of the voting power of the company and held the right to elect three-quarters of the board. In *Dolan*, the court held "[e]ntire fairness is not the default standard for compensation awarded by an independent board or committee, even when a controller is at the helm of the company." The court conceded that the question of what standard of review to apply to a transaction where a controlling stockholder receives a benefit is one that "only the Delaware Supreme Court can resolve." Ultimately, the Delaware Supreme Court decided not to accept an interlocutory appeal.

This opinion is also noteworthy because the court discussed the scope of the *Aronson v. Lewis* test for demand futility as it relates to the applicable standard of review for controlling stockholder transactions. The court limited the breadth of the *Aronson* test, where a demand on the board to pursue litigation is found to be futile if particularized allegations create a "reasonable doubt" either that the directors are "disinterested and independent" or that "the challenged transaction was otherwise the product of a valid business judgment." The Supreme Court in *Aronson* held that if a stockholder plaintiff fails to establish demand futility, a board's refusal to sue is subject to business judgment review. The court discussed post-*Aronson* case law in detail and expressed the view that *Aronson* should not "limit the substantive application of the entire fairness framework" to a controlling stockholder transaction. In other words, "[a]bsent further guidance from the high court," *Aronson* should not limit the application of heightened entire fairness review to transactions where a controlling stockholder receives a special benefit.

Thomas Sandys v. Mark J. Pincus, et al. and Zynga, Inc.

Most recently, in February 2016, the court granted the defendants' motion to dismiss the plaintiff's derivative claims for failure to plead demand futility. Applying the demand futility test established by the Delaware Supreme Court in *Rales v. Blasband*, under which demand may be excused if a plaintiff alleges particularized facts establishing a reason to doubt that "the board of directors could have properly exercised its independent and disinterested judgment in response to a demand," the court concluded that demand was not excused for any of the plaintiff's claims. This is notable because the court applied the standard from *Rales* — which traditionally applies only where the board on which demand would be made did not make an underlying business decision for the transaction challenged in litigation — in circumstances where the *Aronson v. Lewis* test could traditionally apply, and discusses its belief that the *Rales* test could be used universally to assess questions of demand futility.

In this case, a purported stockholder brought claims regarding Zynga's 2012 secondary offering, arguing that the board had breached its fiduciary duties by approving the secondary offering and amending "lock-up" agreements with underwriters. By doing so, the plaintiff claimed, certain board members misused confidential information and were able to sell their Zynga shares based on nonpublic knowledge that Zynga's value would drop. The plaintiff also raised a *Caremark* claim for lack of oversight against the board for failing to ensure adequate controls were in place and failing to disseminate material information before the offering.

The Zynga board on which any demand to bring derivative litigation would have been made was the same board that approved the challenged secondary offering. In such circumstances, the Court of Chancery would traditionally apply the *Aronson* test. Nonetheless, the court applied the *Rales* test to all three of the plaintiff's claims and found that demand was not excused.

The court gave several reasons for this break from the traditional demand futility analysis. According to Chancellor Andre G. Bouchard, Rales "provides a clearer, more straightforward formulation to probe the core issues in the demand futility analysis for each board member who would be considering plaintiff's demand." Rather than focusing on whether a majority of the board who approved the secondary offering would also have considered a demand, he analyzed whether a majority of the board was disinterested and independent. Notably, the court indicated that the *Rales* decision could be applied more widely and replace the *Aronson* test.