Why Boards Shouldn't Reject Investors' Misconduct Claims

By **Aaron Morris** (December 7, 2021)


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In Drachman v. Cukier, decided in October, the Delaware Court of Chancery held that a board wrongfully refused a stockholder demand because it was "reasonable to infer that the directors just did not care about complying with the legal requirements of Delaware law."[1]

The decision is a reminder to directors that their fiduciary duties do not permit them to cursorily refuse a legitimate stockholder demand, and a reminder to investors that they have meaningful legal options if a board refuses to remedy clear corporate misconduct.

Independent directors should consider more direct and creative responses than the all-too-typical outright rejection.

The Demand Requirement

The prelitigation demand requirement is a creature of practicality under corporate law. It requires that a stockholder, before bringing a derivative action on behalf of the company, first demand that the claims be brought by the company's board of directors, unless such a demand would be futile.

The requirement attempts to balance the board's authority to manage the company, including whether to pursue litigation, against the ability of stockholders to protect themselves from corporate misconduct.

As it turns out, however, directors are commonly front and center in corporate wrongdoing, and aren't typically interested in suing themselves or their current or former colleagues. In a lay person's view, one might argue that a demand is almost always futile.[2] Anecdotally, question when you last saw a board recover significant value for a company following internal misconduct, whereas derivative plaintiffs routinely do.

Nonetheless, courts have established — largely for practical reasons — that something more than futility in the lay sense is required to find a board too conflicted to consider a demand,[3] and thus arguing futility is not always an option.

When a stockholder makes a prelitigation demand, the board must reasonably consider it in a manner consistent with its fiduciary duties under state law. If the board rejects the demand, then — quoting from the 2015 case in the Court of Chancery of Delaware, Ironworkers District Council of Philadelphia v. E.I. du Pont de Nemours and Company — the stockholder can pursue the claims only if he or she raises reasonable doubt that "(1) the board's decision to deny the demand was consistent with its duty of care to act on an informed basis, that is, was not grossly negligent; or (2) the board acted in good faith, consistent with its duty of loyalty."[4]

The wrongful-refusal standard is a critical check on boards, although it is not tested often enough because making a demand — so frequently futile in the lay sense — can be a discouraging ordeal, and bad faith is often difficult to show following a process designed by counsel to support the board's rejection.

It can be a powerful tool for stockholders, however, in cases where an obstinate board simply refuses to capture obvious value for the company or fix genuine misconduct.

The Recent Chancery Court Ruling Finding Wrongful Refusal

In Drachman, the company, BioDelivery Sciences International Inc., submitted two proposals at an annual stockholder meeting: first, to declassify the company's board in phases over several years; and second, to change the voting standard for uncontested director elections from a plurality to majority of the votes cast.

Despite that neither proposal garnered the requisite number of votes to pass, the board deemed the two proposals approved and implemented them through two charter amendments. Thereafter, a stockholder made a demand challenging the charter amendments in light of Title 8 of the Delaware Code, Section 242(b), which requires that such amendments be approved by a vote of a majority of the outstanding stock.

A month later, the board refused the demand, stating that it determined that the demand was without merit and declined to take the actions demanded therein. The board purportedly reached this conclusion by excluding broker nonvotes, which the stockholder pointed out was a direct contravention of Section 242 of the Delaware's General Corporation Law and the representations in the company's 2018 proxy.

The stockholder filed a lawsuit alleging breaches of fiduciary duty in connection with the improper charter amendments, and the company moved to dismiss on the basis that the board's consideration and rejection of the stockholder's demand precluded the case.

Two years after the case was filed, stockholders voted to ratify the two amendments, mooting claims with respect to the company's charter. However, the court continued to consider whether the board's sloppy handling of the charter amendments and its rejection of plaintiff's demand constituted independent breaches of fiduciary duty.[5]

Based on the pleadings, the court held that stockholders had raised reasonable doubt that the board acted in good faith in rebuffing the demand. The court held that "the demand pointed out a straightforward violation of Section 242(b), yet — despite the language of the 2018 proxy explaining how votes would properly be tabulated — the board rejected the demand and waited nearly a year to remedy the mistake."

The court credited allegations that the demand had made plain the company's errors and that the "proposals did not receive the number of votes required," but nonetheless the board did "what no responsibly advised directors acting in good faith would ever do: nothing."

Rather than acknowledge its mistake and take prompt corrective action, the board through counsel effectively gave the demand the back of the hand.

Takeaways for Boards and Investors

The ruling in Drachman was not novel in a legal sense: The good faith standard applicable to a board's consideration of a demand is well established.

It's more interesting as a data point on the spectrum of factual circumstances under which a board may or may not get away with doing nothing. Indeed, demand refused cases almost never hinge on the adequacy of a board's corrective action. Rather, the board usually has taken no corrective action at all, and thus the case centers around the board's basis for deciding to do nothing.

The ruling in Drachman makes clear that when a board is confronted with a clear violation of corporate law, it may not do nothing. Nor will it get away with superficial arguments dismissing an investors' contentions.

Although the ruling was based on plaintiffs' allegations and not facts proven at trial, the board's process does appear to have been cursory — a one-month-process that concluded the demand was totally without merit — and its reasoning in rejecting the investor's demand was weak enough to draw the court's rebuke.

The law requires boards to comprehensively investigate a demand, form a reasoned opinion based on the law and facts, and take immediate action to correct unlawful conduct — even technical errors like the ones at issue in Drachman. The failure to properly consider and respond to a demand on a timely basis will subject directors to independent liability even if the original misconduct is corrected in the natural course.

While cases involving a more typical exercise of business judgment may present closer calls, and continue to be difficult for stockholders to advance, rulings in cases like Drachman should restore investors' confidence in placing a straightforward demand in the hands of a board — arguably the outcome preferred by corporate law principles.

Courts will hold directors accountable for refusing to remedy clear misconduct or obtain obvious value for stockholders under circumstances like statutory violations, insider trading by officers, material liability claims belonging to the company and others. In considering a demand, directors should carefully consider their options before an outright rejection.

While a total rejection may be a common outcome, it's also often unsupported. Stockholder demands are not usually made by coincidence or for entertainment — most stockholder lawyers are paid on contingency.

Indeed, historically, derivative plaintiffs have recovered billions of dollars for companies under the demand-futility rubric — almost always with the opposition of company directors — while it seems that boards rarely recover value for companies when asked to address internal misconduct directly.

Diligent and creative directors acting proactively may find ways at the demand stage to address legitimate corporate claims, satisfy or moot the demanding stockholders, and avoid needless litigation expenses and distraction. In so doing, they will strengthen stockholders' confidence in the company's governance and the prelitigation demand mechanism.

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[1] Drachman v. Cukier , No. CV 2019-0728-LWW, 2021 WL 5045265, at *8 (Del. Ch. Oct. 29, 2021).

[2] See Lund, Andrew C.W., Rethinking Aronson: Board Authority and Overdelegation, U. Pennsylvania Journal of Business Law, Vol. 11:3 (2001) (discussing the "strong bias" view that "that demand is, in fact, almost always futile").

[3] To demonstrate that a demand would be legally futile, stockholders must show that a majority of directors "received a material personal benefit from the alleged misconduct that is the subject of the litigation demand," "face[] a substantial likelihood of liability," or "lack[] independence from someone who received a material personal benefit from the alleged misconduct . . . or who would face a substantial likelihood of liability." United Food and Commercial Works Union v. Zuckerberg , No. 404, 2020, 2021 WL 4344361, at *17 (Del. Sept. 23, 2021).

[4] Ironworkers Dist. Council of Phila. & Vicinity Ret. & Pension Plan v. Andreotti , No. 9714–VCG, 2015 WL 2270673, at *24 (Del. Ch. May 8, 2015), aff'd, 132 A.3d 748 (Del. 2016).

[5] Specifically, the plaintiff's breach of fiduciary duty claims were based on: "(a) deeming the [proposals] approved in violation of the DGCL, (b) filing the Amendments with the Delaware Secretary of State, (c) implementing the amendments, (d) refusing to take appropriate action in response to the demand, and (e) moving to dismiss [the] action." Drachman, 2021 WL 5045265 at *3.