

Demand Refused Rule 23.1 Explained by the Delaware Court of Chancery

Delaware Law Update

05.05.2016

Related People:

Daniel J. Brown

In a recent decision out of the Delaware Court of Chancery – *Friedman v. Maffei et al.*, C.A. No. 111105-VCMR – the court’s second-newest member, Vice Chancellor Montgomery-Reeves, dismissed a proposed derivative complaint on the grounds of the rarely invoked test under Chancery Rule 23.1 for demand wrongfully refused. As a quick refresher (or for those who are unfamiliar with the concept of demand futility), when a stockholder of a corporation seeks to sue the directors of that corporation for harm allegedly caused to that corporation based on the directors’ alleged misdeeds, Rule 23.1 requires the stockholder to first either (1) make a request to the board of directors to take some corrective action (*i.e.*, the demand) prior to filing suit or (2) file the suit without making the demand and allege sufficient particularized facts to raise a reasonable doubt that making the demand would have been futile (*i.e.*, demand futility) because the directors are incapable of considering that demand (for some reason such as a particular director’s interest in the underlying transaction). Where a derivative plaintiff makes a demand and the board determines not to act, the plaintiff can still file suit, but in order to avoid dismissal under Rule 23.1, that plaintiff will need to demonstrate that the board wrongfully refused the demand by alleging “particularized facts that raise a reasonable doubt as to whether the board’s decision to refuse the demand was the product of valid business judgment.” *Id.* at 22.

The plaintiff, a stockholder of TripAdvisor Inc., claimed that current and former TripAdvisor directors and executives breached their fiduciary duties and harmed TripAdvisor by improperly allowing former TripAdvisor director Mr. Khosrowshahi to retain and receive immediate vesting of his TripAdvisor restricted stock units (the “RSUs”) upon his departure from the TripAdvisor board. In addition to serving on TripAdvisor’s board, Khosrowshahi also served as the CEO of Expedia, which spun off TripAdvisor as a separate company in December 2011. The plaintiff claimed that the treatment of Khosrowshahi’s RSUs violated the vesting provision of the agreement between TripAdvisor and Khosrowshahi (the “RSU Agreement”). In addition to permitting RSUs to vest upon various performance targets, the RSU Agreement allowed for 50% of Khosrowshahi’s RSUs to vest immediately upon a “Change in Control” regardless of performance, and for the other 50% to vest so long as Khosrowshahi remained on the board for one year following the Change in Control or was terminated without cause during that same one-year period. If, however, Khosrowshahi voluntarily

resigned or was terminated for cause, then he would forfeit the remaining 50%.

In December 2012, there was a Change in Control. Thus, pursuant to the RSU Agreement, 50% of Khosrowshahi's RSUs vested immediately, and the one-year period for the remainder of Khosrowshahi's RSUs to vest if he either remained on the board or was terminated without cause started. Additionally, in December 2012 Expedia acquired a controlling stake in Trivago GmbH. As part of that agreement, Trivago would continue to operate independent of Expedia, with Expedia playing no role in Trivago's management. The same day the Expedia/Trivago transaction was announced, Khosrowshahi contacted TripAdvisor's CEO about the transaction and to advise the CEO that he would understand if the TripAdvisor management team wanted him off the board. TripAdvisor's CEO expressed his view to the other board members that Trivago competed with TripAdvisor and ultimately determined that it would be best for Khosrowshahi to resign from the TripAdvisor board. In February 2013, TripAdvisor's general counsel contacted Khosrowshahi to request his resignation and to state that his resignation would constitute a termination of service under the RSU Agreement, which would cause the remainder of Khosrowshahi's RSUs to vest immediately. Khosrowshahi resigned two hours later.

Prior to filing suit, the plaintiff made a demand of the TripAdvisor board to investigate the manner in which Khosrowshahi was allowed to retain and receive immediate vesting of his RSUs, and to take corrective action. The plaintiff claimed that Khosrowshahi voluntarily resigned from the board following the Expedia/Trivago deal and that he was not terminated without cause; rather, that he was terminated for cause due to the fact that TripAdvisor and Trivago competed against each other. Based on the above, the plaintiff claimed that pursuant to the RSU Agreement, Khosrowshahi forfeited his RSUs and the TripAdvisor CEO and general counsel violated the RSU Agreement by accelerating the vesting of Khosrowshahi's RSUs.

In response to the plaintiff's demand, the TripAdvisor board created a special committee of the board to investigate the plaintiff's allegations. The special committee conducted its investigation and prepared a detailed report. Based on the investigation, the special committee determined (1) that Khosrowshahi did not voluntarily resign; (2) that Khosrowshahi was terminated without cause due to the Expedia/Trivago transaction; and (3) that the potential benefits of litigation against former and current TripAdvisor management were outweighed by the costs of litigation, including Khosrowshahi's potential claims against TripAdvisor for breach of the RSU Agreement, the possibility of having to pay management's legal fees due to their rights to advancement and indemnification, and the distraction the litigation would have on the company's day-to-day operations. In light of the investigation, the special committee recommended that the board deny the plaintiff's demand, which it did.

Regardless of the special committee's determination, the plaintiff filed suit based on the same alleged wrongdoing as stated in the demand and also attempted to allege facts to establish that the board wrongfully refused the demand. The defendants moved to dismiss under Rule 23.1, based on the findings of the special committee's investigation. The court agreed and determined that the complaint failed to allege particularized facts that would raise a reason to doubt that the board's decision was a valid business judgment. The court also reiterated that in a demand wrongfully refused case, a plaintiff's mere disagreement with a board's conclusion will be insufficient to raise a reasonable doubt that the board acted in good faith and on an informed basis. Rather, the plaintiff must allege particularized facts that would raise a reasonable doubt that the board (1) acted consistent with its duty of care (*i.e.*, was not grossly negligent in conducting the investigation) or (2) acted in good faith, consistent with its duty of loyalty by refusing the demand. While opinions ruling on Rule 23.1 issues are, by definition, fact specific, *Maffei* is worthy of consideration because it reinforces that whenever a company receives a stockholder demand it would be wise for the board to appoint a special committee of disinterested directors to conduct a detailed and thorough investigation of that

demand, because by doing so the board is best positioned to demonstrate that it complied with its fiduciary duties. This is significant from a corporate governance standpoint. Additionally, *Maffei*, like the Court of Chancery's decision in *Ironworkers Dist. Council of Phila. & Vicinity Ret. & Pension Plan v. Andreotti*, 2015 WL 2270673, at *25 (Del. Ch. May 8, 2015), *aff'd*, 2016 WL 341201 (Del. Jan. 28, 2016), reiterates just how onerous the demand wrongfully refused test is for derivative plaintiffs to overcome and explains why few derivative plaintiffs elect to make a demand when they believe that the directors have committed acts which cause harm to the corporation.