

Delaware Supreme Court Addresses Bad-Faith Pleading Standard, Affirms Dismissal of Derivative Suit

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On January 13, 2020, a panel of three justices from the Supreme Court of Delaware issued an opinion affirming the Court of Chancery's dismissal with prejudice of a stockholder derivative action against the board of directors of Uber Technologies, Inc. (Uber) for failure to make a pre-filing demand on Uber's board pursuant to Court of Chancery Rule 23.1.

The case related Uber's December 2016 acquisition of Ottomotto LLC (Otto). As part of due diligence for the transaction, Uber retained a computer forensic investigation firm (Stroz) to investigate whether Otto employees, many of whom had recently been lured away from Google to work for Otto, took with them Google's proprietary information or might breach nonsolicitation, noncompete, or fiduciary obligations if they moved from Google to Otto. The investigation allegedly revealed that Otto employees had "retained, accessed, or deleted confidential Google information on their personal devices after their departure from Google." The Uber board was aware of the investigation; however, the complaint alleges that the Uber board did not actually review the report in connection with the consideration and approval of the Otto transaction, due in part to the board's alleged reliance on ex-Uber CEO Travis Kalanick.

After the acquisition closed, Google sued Otto and Uber for alleged intellectual property infringement. Uber settled the dispute for \$245 million, prompting an Uber stockholder (the plaintiff) to file the underlying derivative action against the Uber directors who decided to proceed with the Otto transaction, the directors who decided to close the transaction, and two Uber officers, seeking damages flowing from the transaction. The plaintiff did not make a pre-filing demand on the Uber board as required by Court of Chancery Rule 23.1. According to the plaintiff, a demand on the Uber board would have been futile because a majority of the Uber directors at the time he filed his complaint were interested or not independent of others who were interested.

The defendants moved to dismiss the action under Court of Chancery Rule 23.1 based on the plaintiff's failure to make a pre-filing demand and failure to adequately allege demand futility. The directors argued that the board could have impartially considered a demand, as required under Supreme Court precedent, *Rales v. Blasband*. Addressing the motion, the Court of Chancery found that only one Uber director — Kalanick — was interested in the Otto transaction and that a majority of the board

in place at the time of the complaint was independent from him. Accordingly, the Court of Chancery dismissed the action based on the plaintiff's failure to make a pre-filing demand on the Uber board. The plaintiff appealed the dismissal to the Delaware Supreme Court.

In his appeal, the plaintiff first asserted that the Court of Chancery erred in dismissing his claims because a majority of the Uber directors faced a substantial likelihood of personal liability for the conduct alleged in the complaint. Because Uber's certificate of incorporation contained a provision exculpating Uber's directors from monetary liability for breaches of the fiduciary duty of care, the plaintiff was required to plead with particularity that a majority of the directors acted in bad faith in connection with their approval of the transaction. The Supreme Court rejected the plaintiff's first attempt to show bad faith by arguing that a majority of the board improperly relied on the guidance of Kalanick in their consideration of the deal. Instead, the Court found that other allegations in the complaint showed "a functioning board that did more than rubberstamp the transaction presented by Uber's CEO." The plaintiff next argued that "unusual indemnification clauses in the merger agreement" should have put the board on notice "that Kalanick wanted to steal Google's proprietary information." The Supreme Court noted that while unusual, the complaint alleged that those provisions were "clearly explained to the board" and did, in fact, provide some protection for Uber. Thus, the Supreme Court agreed with the Court of Chancery that the complaint did not support a reasonable inference that the directors acted in bad faith in approving the deal.

Notably, the Supreme Court distinguished the plaintiff's complaint from the holding *In re Walt Disney Co. Derivative Litigation*, where the Court of Chancery found that "the facts alleged . . . suggest that the defendant directors consciously and intentionally disregarded their responsibilities . . ." The Court explained that "[u]nlike *Disney*, where the directors devoted very little time, had no presentations, and asked no questions," the Uber board met to consider the Otto acquisition and took other reasonable steps to assess the deal. Thus, the panel found that the board's failure to investigate further could not be characterized fairly as "an 'intentional dereliction' of its responsibilities."

In a second attempt to salvage his claims, the plaintiff asserted that the Court of Chancery erred in dismissing his claims because a majority of the directors were too close to Kalanick for them to properly exercise their business judgment in responding to a demand relating to the Otto acquisition. Accepting that Kalanick was interested in the Otto transaction, the Supreme Court explained that the fate of the plaintiff's claim turned on whether the plaintiff had successfully alleged that at least five of the remaining ten directors were not independent of Kalanick. The Supreme Court agreed with the Court of Chancery that the plaintiff had failed to plead that one of the contested directors, Thain, whom the plaintiff asserted was not independent of Kalanick because Kalanick had appointed him to the board "during a power struggle" between Kalanick and Uber, was not independent. The plaintiff had failed to allege that Thain had a personal or financial connection to Kalanick or that the directorship was of substantial material importance to him, as required in order to call Thain's independence into question.

The Supreme Court's opinion marks a significant contribution to the body of precedents assessing demand futility and applying the standard articulated in *Rales v. Blasband*. The opinion confirms the long-recognized principle that "there is a vast difference between an inadequate or flawed effort to carry out fiduciary duties and a conscious disregard for those duties." The opinion also serves as a helpful reminder that the fact that a director may have been nominated or elected by a director who controls the company is insufficient by itself to reasonably doubt a director's independence.

McElrath v. Kalanick, No. 181, 2019 (Del. Jan. 13, 2020)