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The Court of Chancery Dismisses Derivative Suit Against TrueCar Officers and Directors, Finding Plaintiffs Failed to Allege Substantial Risk of Liability by a Majority of the Board

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Under Court of Chancery Rule 23.1, a stockholder who wishes to bring a derivative claim on behalf of a corporation must “allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors [of the company] or comparable authority and the reasons for the plaintiff’s failure to obtain the action or for not making the effort.” The latter concept is known as “demand futility.”

In an opinion issued September 30, 2020, the Court of Chancery dismissed a derivative consolidated complaint alleging that officers and directors of TrueCar, Inc., anticipated the harmful effect a partner’s website redesign would have on TrueCar’s sales, and that certain defendants sold off their personal shares before a November 2017 earnings report revealed the extent of the harm, for plaintiffs’ failure to make demand upon the board or to adequately plead demand futility.

TrueCar claims to offer prospective car buyers the “true” market price for new and used vehicles. The company is allegedly dependent on “affinity partner” organizations that direct internet traffic to TrueCar’s co-branded sites. One such partner, USAA Insurance, accounts for almost one-third of TrueCar’s annual revenue. The complaint alleged that, in January 2017, USAA decided to redesign its website to de-emphasize car purchasing and access to TrueCar. The complaint further alleged that TrueCar’s directors and officers were aware that the redesign would have a negative impact on TrueCar’s sales, but failed to disclose it while also completing a secondary public offering of one million shares. The company’s chief financial officer, chief accounting officer, chief marketing officer, and chief legal officer sold millions of their own TrueCar shares, generating significant personal profits.

Notwithstanding the company’s previously positive public filings, the company reported a $9.5 million net loss for the third quarter of 2017 and announced that it would be reducing its sales and revenue guidance for the year. Upon the announcement, the company’s stock price had plummeted more than 35%.

In the derivative consolidated complaint, filed November 9, 2019, TrueCar stockholders asserted various derivative claims, including breach of fiduciary duty, insider trading, unjust enrichment, and aiding and abetting a breach of fiduciary duty against current and former TrueCar officers and directors, along with entities that sold stock in a 2017 secondary public offering.

According to the court, “The threshold issue in this case is whether plaintiffs’ failure to make a demand on the TrueCar board to initiate litigation should be excused." Dismissing the suit in its entirety, the court found that plaintiffs "failed to plead particularized facts sufficient to impugn the ability of any of the members of the demand board, let alone a majority, to have considered a demand impartially," as contemplated under Court of Chancery Rule 23.1. The court determined that the allegations did not demonstrate that the directors on which demand would be made (the "Demand Directors") knew about the USAA website redesign that was implemented in June 2017 or its potential impact on TrueCar's financial performance until they were briefed on the issue at a September 15, 2017, board meeting, or that they failed to appropriately monitor the situation.

The court distinguished the Demand Directors' knowledge from company management's, stating that "[t]he critical question…is not when TrueCar's management learned about the website redesign, but when the members of the Demand Board were informed about the redesign and understood its significance to TrueCar's financial performance." The court noted that "vague references" in board materials to underperformance or a need to "re-energize" the company's relationship with USAA were not sufficient to infer that the board had knowledge of the impending issues sufficient to give rise to a substantial likelihood of liability for any of the claims.

The court also determined that the plaintiffs failed to "allege particularized facts to allow a reasonable inference that TrueCar management provided reports to or otherwise informed the Board about any expected changes to the USAA website at any time before the Secondary Offering closed." Therefore, to the extent certain Demand Directors had participated in the offering, the complaint did not support "a reasonable inference" that any of them possessed material nonpublic information when they traded, much less that they consciously acted to exploit such information."

Finally, the court rejected plaintiffs' arguments that the Demand Directors would be unable to impartially consider a demand due to the existence of a parallel securities class action that named several of the directors as defendants based on similar allegations. The court found that "none of the six Demand Board directors named in that case face a substantial likelihood of liability in the Securities Class Action because they would be exculpated for all the claims asserted against them" in that action due to an exculpatory provision in the company's charter and because a settlement agreement executed in that action "eliminated as a practical matter" any exposure to personal liability.

The opinion is significant because it clarifies the court's perspective on the level of detail required to sufficiently allege demand futility and confirms that directors may be found to be impartial based on lack of knowledge provided that they did not ignore "red flags" or fail to appropriately discharge their oversight duties.