

Ninth Circuit Clarifies Delaware Demand Futility Standard in Derivative Case

June 14, 2018

On June 13, 2018, the U.S. Court of Appeals for the Ninth Circuit issued an opinion in *Tindall v. First Solar Inc.*, affirming the district court’s dismissal of a derivative action for failure to show demand futility. No. 17-15185 (9th Cir. June 13, 2018). The court held that Delaware’s *Aronson* test for demand futility is limited to cases involving affirmative business decisions made by a board, and does not apply where a shareholder seeks to challenge the board’s sign-off regarding a corporation’s financial statements or press releases. A plaintiff complaining about such routine matters can avoid making a demand on the corporation’s board only by showing compliance with the test announced by the Delaware Supreme Court in *Rales v. Blasband*, 634 A.2d 927 (Del. 1993), discussed further below.

In *Tindall*, plaintiffs brought a shareholder derivative action accusing First Solar’s directors and officers of breaching their fiduciary duties by “failing to disclose in financial statements and press releases the existence of manufacturing and design defects” allegedly found in the company’s solar panels. *Id.* at 3-4. Plaintiffs did not make a presuit demand to the board before bringing their derivative action. Accordingly, they were required to show demand futility (i.e. that it would have been pointless to demand corrective action before filing the litigation). *Id.* at 4-5.

Applying Delaware law, the Ninth Circuit held that Delaware’s *Aronson* test—which requires plaintiffs to allege particularized facts creating a reason to doubt either that (1) “the directors are disinterested and independent” or (2) the “challenged transaction was otherwise the product of a valid exercise of business judgment”—is limited to board *business* decisions, and does not apply to *all* board conduct, including the approval of financial statements. *Id.* at 5-6 (discussing *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984)). The court concluded that only affirmative business decisions “implicate the business judgment rule” invoked by the second prong of the test. *Id.* at 6-7 (collecting cases). The court held that the conduct at issue in this case—namely, the approval of the company’s financial statements and press releases—was not a “business decision” because such an approval “reflect[ed] business judgments already made” rather than “weighing the risks and rewards of future conduct,” which is the “type of decision-making process the business judgment rule is designed to protect.” *Id.* at 7.

Having concluded that the *Aronson* test for demand futility did not apply, the court concluded that the plaintiff was required to satisfy a competing Delaware standard called the *Rales* test, which Delaware courts apply to claims involving lack of board oversight. *Id.* at 7-8. In *Rales*, the Delaware Supreme Court concluded that a court must “examine whether the board that would be addressing the demand can impartially consider its merits without being influenced by improper considerations. Thus, a court must determine whether or not the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand. If the derivative plaintiff satisfies this burden, then demand will be excused as futile.” *Rales*, 634 A.2d at 934;

see also *In re Yahoo! Inc. Shareholder Derivative Litig.*, 153 F. Supp. 3d 1107, 1119 (N.D. Cal. 2015) (discussing the *Rales* test).

The decision suggests that where a board engages in routine approvals that cannot properly be characterized as affirmative business decisions, a derivative plaintiff cannot establish demand futility unless the plaintiff can show that the board would be unable to assess a shareholder demand in an objective and disinterested fashion.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Andrew Ditchfield	212 450 3009	andrew.ditchfield@davispolk.com
Charles S. Duggan	212 450 4785	charles.duggan@davispolk.com
Michael S. Flynn	212 450 4766	michael.flynn@davispolk.com
Edmund Polubinski III	212 450 4695	edmund.polubinski@davispolk.com
Lawrence Portnoy	212 450 4874	lawrence.portnoy@davispolk.com
Neal A. Potischman	650 752 2021	neal.potischman@davispolk.com
James P. Rouhandeh	212 450 4835	rouhandeh@davispolk.com
Andrew Yaphe	650 752 2088	andrew.yaphe@davispolk.com