



January 2010

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Shareholder Derivative Plaintiffs Claiming Demand Excusal Based on Lack of Director Independence and Disinterestedness Face High Hurdle

The requirement that shareholders make a demand upon the company's board of directors before proceeding with a derivative action is black-letter corporate law. So too is the so-called "demand excusal" – codified in Delaware Court of Chancery Rule 23.1 – which excuses a derivative plaintiff's demand requirement if the plaintiff pleads, with particularity, reasons for failing to make the demand. Nevertheless, the question of what particular facts and circumstances are sufficient to support demand excusal continues to be a source of controversy and development.

To support demand excusal, shareholder plaintiffs frequently rely on allegations of a lack of director independence or disinterestedness. However, as noted in the recent *Robotti & Co. LLC v. Liddell*, No. 3128-VCN (Del. Ch., Jan. 14, 2010) decision, establishing a lack of director independence or disinterestedness in the demand excusal context can be a high hurdle.

In *Robotti*, a shareholder plaintiff brought class and derivative actions challenging a shareholder rights offering. The *Robotti* plaintiff alleged that the company's directors set the offering price at a deliberately and inadequately low price in order to trigger certain anti-dilution provisions which favored the directors but not remaining shareholders. As such, the *Robotti* plaintiff asserted derivative claims against the directors based

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on self-dealing and breaching the duty of loyalty.

The *Robotti* plaintiff argued that demand excusal was appropriate under the circumstances because the challenged rights offering provided the directors with a personal benefit not shared by other shareholders, and therefore, the directors could not be disinterested with regard to the corresponding derivative action demand.

In rejecting the *Robotti* plaintiff's plea for demand excusal, the Delaware Court of Chancery provided a detailed discussion of the standards applicable in determining whether directors are "interested" for demand excusal purposes. Specifically, the Court noted that "the mere fact that a director received some benefit that was not shared generally by all shareholders is insufficient; the benefit must be *material*" (emphasis added). Moreover, the Court noted, the "plaintiff must show that the alleged benefit was significant enough *in the context of the director's economic circumstances*, as to have made it improbable that the director could perform her fiduciary duties to the shareholders without being influenced by her overriding personal interest" (internal quotes omitted, emphasis in original).

Determining director independence in the demand excusal context required the Court to ask "whether the directors are so ' beholden ' to an interested director or interested controlling shareholder that their 'discretion would be sterilized.'" Accordingly, the Court repeatedly emphasized the fact that mere personal or business friendships do not establish a lack of director independence for demand excusal purposes, noting "various motivations, including friendship may influence this inquiry; but to render a director unable to consider demand, a *relationship must be of a bias-producing nature* " (internal citations omitted, emphasis added). Moreover, showing a director to be interested with regard to demand requires showing "a relationship between the disinterested director and the interested director or controlling shareholder 'that is so close' that one could infer that 'the non-interested director would be more willing to risk his or her reputation than risk the relationship with the interested director.'"

The *Robotti* decision demonstrates the difficulties facing shareholder plaintiffs who cite lack of director independence and disinterestedness as a basis for demand excusal. Squire Sanders has significant experience responding to shareholder derivative actions and shareholder pleas for demand excusal. For further information on demand excusals, please contact your principal Squire Sanders lawyer or one of the individuals

listed in this Alert.



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2010

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