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IN THE

Supreme Court of the State of Delaware

UNITED FOOD AND COMMERCIAL WORKERS UNION AND PARTICIPATING FOOD INDUSTRY EMPLOYERS TRI-STATE PENSION FUND,

Plaintiff-Below,
Appellant,

v.

MARK ZUCKERBERG, MARC ANDREESSEN, PETER THIEL, REED HASTINGS, ERSKINE B. BOWLES, AND SUSAN D. DESMOND-HELLMANN,

Defendants-Below,
Appellees,

- and -

FACEBOOK, INC.,

Nominal Defendant-Below,
Appellee.

No. 404, 2020

CASE BELOW:

COURT OF CHANCERY OF THE STATE OF DELAWARE,
C.A. No. 2018-0671-JTL

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NATURE OF PROCEEDINGS

In 2016, Facebook's board and stockholders approved a transaction that would have created a new class of non-voting stock and implemented governance modifications ensuring the eventual end of the company's controlling-stockholder structure. That Reclassification proposal was never executed. Shortly after it was announced, the Reclassification was challenged in a certified stockholder class action. After more than a year of litigation, Facebook terminated the proposed Reclassification. Having achieved what they described as "the full relief sought" in the case, class counsel dismissed the action as moot and applied for and ultimately received a fee for their efforts.

Plaintiff then filed this derivative action. The allegations of the complaint repeat the prior suit's arguments against the terminated Reclassification. But this action does not challenge that transaction. Instead, plaintiff seeks to recover from the director defendants expenses that Facebook incurred during the consideration and then litigation of the proposed Reclassification.

The Court of Chancery dismissed the complaint for failure to plead demand futility with particularity, as required by its Rule 23.1. The court decided against applying the test for demand futility set forth in *Aronson* v. *Lewis*, 473 A.2d 805 (Del. 1984), as traditionally formulated. Instead, it applied a version of the test set forth in *Rales* v. *Blasband*, 634 A.2d 927 (Del. 1993), that the court stated was

intended to fully incorporate the two-part *Aronson* inquiry. The court concluded that the complaint did not adequately plead that a majority of the board was not independent or disinterested with respect to the terminated Reclassification. The court also concluded that the complaint did not adequately plead bad faith or otherwise non-exculpated conduct by a majority of the board that could undermine its ability to consider a demand in the best interests of the corporation. Because the court's analysis was consistent with the proper application of the controlling *Aronson* test, its order dismissing the complaint should be affirmed.

SUMMARY OF ARGUMENT

1. **Denied.** The complaint does not satisfy the second prong of the *Aronson* test for demand futility. The Court of Chancery correctly applied nearly unanimous Delaware authority in holding that demand is futile under *Aronson*'s second prong only if the plaintiff pleads particularized facts showing that a majority of the board faces a substantial likelihood of liability for non-exculpated claims. Facebook's certificate of incorporation contains a provision that exculpates directors to the fullest extent permitted by Delaware law. On appeal, plaintiff does not contest that the complaint fails to plead non-exculpated claims against a majority of the board. Demand was therefore not futile under the second prong of the *Aronson* test. Plaintiff's contrary arguments—primarily based on a single decision that the Court of Chancery has expressly declined to follow—are without merit.

2. **Denied.** The complaint does not satisfy the first prong of the *Aronson* test for demand futility. After a thorough analysis of plaintiff's allegations, the Court of Chancery correctly held that the complaint does not allege particularized facts sufficient to show that at least five of the company's directors were interested in the challenged transaction or beholden to someone who was. On appeal, plaintiff contests only the court's holding that the complaint failed to plead with particularity that a majority of the board was not independent. Plaintiff, however,

does not identify any particularized allegations of fact, overlooked by the court, that would give reason to doubt a majority of the board's ability to objectively consider a demand in the best interests of the corporation. That is because the complaint does not contain any.

STATEMENT OF FACTS

A. Facebook

Facebook, Inc. is incorporated in Delaware and headquartered in California. A19. Since its initial public offering in 2012, Facebook has had two classes of stock: Class A stock with one vote per share, and Class B stock with ten votes per share. A22-23. After the completion of the IPO, Mark Zuckerberg—Facebook's founder, chairman, and chief executive officer—held 22.9% of the company's outstanding capital stock and, by virtue of his Class B stockholdings and voting proxy agreements, controlled 57.6% of its voting power. A23.

The high-vote Class B shares generally convert to low-vote Class A shares when transferred but retain their voting power if they are transferred (including by inheritance) to family members of the holder or to entities exclusively owned by the holder or by family members of the holder. *Id.* Nothing in Facebook's governing documents places conditions on Zuckerberg's retention of majority voting control or requires him or his family transferees to relinquish voting control.

Facebook's certificate of incorporation obligates the company to indemnify its directors and officers "to the fullest extent permitted by law." B77. Facebook's certificate of incorporation also contains an exculpation provision authorized by 8 *Del. C.* § 102(b)(7). *See id.* ("To the fullest extent permitted by law, no director of

the corporation shall be personally liable to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director.").

B. Facebook's board of directors

As of the date the amended complaint was filed, Facebook's board of directors had nine members. A46. Two directors were also officers: Zuckerberg and Sheryl Sandberg, the company's chief operating officer. *Id.* The remaining seven were all outside directors who have never been employed by Facebook:

Jeffrey Zients served as a director from May 2018 to May 2020. *Id.* At the time, he was the chief executive officer of Cranemere Group Limited, a diversified holding company. B117. From 2009 to 2017, Zients served in the Obama administration, including as Director of the National Economic Council and Acting Director of the Office of Management and Budget. *Id.*

Kenneth Chenault served as a director from February 2018 to May 2020. A46. Chenault has been chairman and a managing director of General Catalyst, a venture capital firm, since February 2018. A63; B116. Chenault served as the chairman and chief executive officer of American Express Company from April 2001 to February 2018. B116.

Erskine Bowles served as a director from September 2011 until May 2019. A21; B181-82. Before joining the Facebook board, Bowles was the president of the University of North Carolina. B116. He served as the White House Chief of

Staff during the Clinton administration and was Co-Chair of the National Commission on Fiscal Responsibility and Reform in 2010. *Id.* Before entering public service, Bowles was an investment banker. *Id.*

Dr. Susan Desmond-Hellmann served as a director from March 2013 to October 2019. A21. From May 2014 to February 2020, she was the chief executive officer of the Bill & Melinda Gates Foundation, a private philanthropic organization funded and controlled by the Gates family and Warren Buffett with an endowment of more than $40 billion. A27, A54. Before joining the Gates Foundation, she was the chancellor of the University of California at San Francisco and held top management positions in the life sciences industry. A28-29; B117.

Reed Hastings served as a director from June 2011 until May 2019. A21; B181-82. He is the co-founder, chairman, and co-chief executive officer of Netflix, Inc., A60, which has a market capitalization of more than $100 billion. When the amended complaint was filed, Hastings owned 2% of Netflix's outstanding stock. B207.

Peter Thiel has served as a director since April 2005. A21. He is a co-founder and partner of several investment and venture capital firms, including Thiel Capital and Founders Fund. B117. Thiel co-founded and served as the chief executive officer of PayPal, Inc. until its sale to eBay, Inc. A57-58; B117.

Marc Andreessen has served as a director since June 2008. A20. He is a co-founder and general partner of Andreessen Horowitz, a venture capital firm. A51. Before starting that firm, he co-founded software companies Netscape Communications and Opsware, Inc. (formerly known as Loudcloud Inc.). B116.

All of the outside directors are independent under the rules of the NASDAQ, the exchange on which Facebook's stock is listed. B119.

C. A Special Committee of Facebook's board negotiates a reclassification with Zuckerberg

In early 2015, Zuckerberg raised with Facebook's general counsel a "potential idea" to "transfer all of his Facebook stock to a charitable organization without ceding voting control of the Company." A24. Facebook's legal team informed Zuckerberg that, given the then-trading price of Facebook stock, he would lose majority voting control if he sold "approximately $3 to $4 billion" worth of his Facebook stock. *Id.* But if Facebook made a pro rata distribution of shares of a new class of non-voting stock to all stockholders (as Google had recently done), then Zuckerberg would be able to sell more of his Facebook stockholdings "without significantly diminishing his voting power." *Id.*

In June 2015, Zuckerberg informed the Facebook board that he intended "to significantly ramp up his philanthropy," funded by sales of his Facebook stockholdings, and "expressed a desire to begin a Board discussion about what these stock sales would mean for Facebook." A24-25. A few months later, at a

Facebook board meeting in August 2015, Zuckerberg proposed that Facebook make a pro rata distribution to all Facebook stockholders of shares of a new, non-voting Class C stock. A26.

The board established a Special Committee to respond to Zuckerberg's proposal. A26. The board authorized the Committee to retain its own advisors, at the company's expense; to evaluate and negotiate any proposal by Zuckerberg to alter the company's capital structure; and to evaluate and negotiate any alternatives to such a proposal. A26-27. The board's independent directors appointed the members of the Audit Committee, Andreessen, Bowles, and Desmond-Hellmann, to serve on the Special Committee. A20, A21, A26-27. Desmond-Hellmann served as the Special Committee's chair. A21.

The Special Committee retained Wachtell, Lipton, Rosen & Katz as its legal advisor, A27, and Evercore Group L.L.C. as its financial advisor, A30. Evercore was paid a $2.5 million fee. *Id*. Morgan Stanley, which was separately engaged to advise the company regarding a potential reclassification, was paid a $2 million fee. A25. The complaint does not allege that any advisor's fees were contingent on any particular outcome, and they were not.

From November 2015 to April 2016, the Special Committee and Zuckerberg negotiated the terms of a potential reclassification. A35. The Committee met multiple times throughout the negotiations, by itself and with Zuckerberg. A38-39.

During the course of negotiations, Zuckerberg "rejected" proposals by the Special Committee to include "'stapling' provisions that would have required [him] to sell a share of Class B stock each time he sold a share of Class C stock" and "a 'true-up' financial payment to the Facebook Class A stockholders." A29-30. According to the complaint, the "Special Committee never demanded that Zuckerberg reconsider his rejected terms" and instead "primarily focused on negotiating the terms of the 'sunset' provisions" that governed the circumstances in which Facebook's multi-class share structure would collapse and Zuckerberg's majority voting control would therefore end. A31, A35.

In December 2015, shortly after the negotiations had begun, Facebook disclosed that Zuckerberg had created a new charitable entity, the Chan Zuckerberg Initiative, and that he had informed the company that "he plans to sell or gift no more than $1 billion of Facebook stock each year for the next three years and that he intends to retain his majority voting position in [Facebook] stock for the foreseeable future." B243. Consistent with this disclosure, the complaint alleges that Zuckerberg "intended to retain majority control of Facebook while selling large amounts of Facebook stock regardless of whether the Reclassification Plan was ever enacted." A44-45. The complaint acknowledges that the Special Committee nevertheless obtained "governance concessions" from Zuckerberg in exchange for agreeing to a reclassification. A39-40.

On April 13, 2016, the Special Committee voted to recommend the proposed reclassification it had negotiated with Zuckerberg (the "Reclassification"). A41. The following day, the full Board—with Zuckerberg and the other inside directors abstaining—approved the Reclassification. *Id*.

As ultimately negotiated, the Reclassification would have created a new Class C of non-voting stock to be distributed as a pro rata dividend of two shares of Class C stock for every one share of Class A or Class B stock. *Id.* The Reclassification was conditioned on multiple changes to Facebook's corporate governance structure. *Id*. The principal changes included:

(1) An automatic conversion provision that collapsed the company's multi-class share structure into a single-class, one-vote-per-share structure when Zuckerberg ceased to serve in an executive leadership role in the company, whether due to his decision to leave the company, death or disability, or termination for cause. (The provision contained an exception, under certain circumstances, for a leave of absence for government service.) B342-43.

(2) A mandatory conversion provision that required Zuckerberg to use his majority voting control of the outstanding Class B stock to effect an automatic conversion of all Class B shares into Class A stock before engaging in any transfer of his Class B stock that would cause him to own less than a majority of the outstanding Class B stock. A41-42; B367.

(3) An equal treatment provision that prohibited the payment of differential consideration to Zuckerberg and minority stockholders not only in mergers or similar transactions, but also in tender or exchange offers by third parties that were agreed to or recommended by the company. B342.

The Reclassification was put to a stockholder vote at Facebook's annual meeting on June 20, 2016. A43. It was approved by a majority of Facebook's outstanding voting power, including all shares held by Zuckerberg. *Id.*

D. Stockholder plaintiffs challenge the Reclassification as a breach of fiduciary duty

After the Reclassification was announced, several plaintiffs filed suit in the Court of Chancery challenging the Reclassification on behalf of Facebook's minority stockholders. The cases were consolidated into a putative class action. A43-44. The complaint asserted two direct claims of breach of fiduciary duty, one against Zuckerberg as controlling stockholder and the other against Facebook's other directors. *See* Consolidated Verified Class Action Complaint, *In re Facebook, Inc. Class C Reclassification Litig.*, C.A. No. 12286-VCL (Trans. ID No. 59094969) (Del. Ch. June 6, 2016), ¶¶98, 103.

The class action complaint alleged that the Reclassification would have a "negative effect . . . on the public Class A stockholders," *id.* ¶10, while allowing Zuckerberg "to donate/monetize his Class C shares without giving up the voting

control he enjoys through his Class B super-voting shares," *id*. ¶8. The complaint sought a permanent injunction against the Reclassification. *Id.* ¶¶107-10.

In May 2016, the Court of Chancery appointed co-lead counsel for the class action. *See* Order Appointing Lead Counsel and Lead Plaintiff, *In re Facebook, Inc. Class C Reclassification Litig.*, C.A. No. 12286-VCL (Trans. ID No. 59017993) (Del. Ch. May 17, 2016) (appointing Grant & Eisenhofer, P.A. and Kessler Topaz Meltzer & Check, LLP as Co-Lead Counsel and Prickett, Jones & Elliott, P.A. as Additional Counsel).

Facebook agreed to not implement the Reclassification pending a final decision by that court. A43-44. Active litigation, including extensive discovery and class certification, proceeded for more than a year. A43.

Before trial was scheduled to begin in September 2017, Facebook determined to withdraw the Reclassification. Facebook publicly announced the following day that the claims alleged in the Class Action were mooted. A43-44; B430-32. The class plaintiffs then voluntarily dismissed the class action—with prejudice as to the named plaintiffs and without prejudice as to the class. *See* Stipulation and Order Dismissing Action as Moot and Retaining Jurisdiction to Determine Plaintiffs' Counsel's Application for an Award of Attorneys' Fees and Reimbursement of Expenses, *In re Facebook, Inc. Class C Reclassification Litig.*, C.A. No. 12286-VCL (Trans. ID No. 61158771) (Del. Ch. Sept. 25, 2017).

After Facebook abandoned the Reclassification, plaintiffs' counsel in the class action applied to the Court of Chancery for a fee award of $129 million, to be paid by Facebook under the corporate benefit doctrine. A45. While the application was pending, Facebook announced that it had settled the fee application by agreeing to pay plaintiffs' counsel $68.7 million in fees and expenses. *Id.*; B439.

E. Plaintiff files this derivative suit

Plaintiff's amended complaint asserts a single derivative claim for breach of fiduciary duty against six current or former Facebook directors: Andreessen, Bowles, Desmond-Hellmann, Hastings, Thiel, and Zuckerberg. The complaint alleges that the defendants breached their fiduciary duties by "knowingly caus[ing] Facebook to approve the Reclassification Plan." A64.

Plaintiff sought as damages the expenses that Facebook incurred as a result of the board's consideration of a potential reclassification and the litigation of the Reclassification as ultimately negotiated. A45, A64-65. These damages are alleged to consist of (1) the $4.5 million in financial advisor fees incurred during the consideration and negotiation of the Reclassification, (2) the approximately $21.8 million in legal fees paid by Facebook for the defense of the class action, and (3) the $68.7 million in plaintiffs' counsel fees that Facebook paid to resolve the class action plaintiffs' mootness fee application. *See id.*

Defendants moved to dismiss the complaint under Court of Chancery Rules 23.1 and 12(b)(6). B1-63. With respect to Rule 23.1, they contended that the *Aronson* test for demand futility applied, but that regardless of whether the *Aronson* or *Rales* test was applied, the complaint failed to meet it. B27. They argued that the complaint necessarily challenged the board's decision to approve each of the three categories of fees outlined above, not the abandoned Reclassification, since the complaint sought as relief only recovery of those fees. B34-35. Because the complaint did not allege that the defendants received any of those fees, or lacked independence from those who did, a demand to institute a suit seeking to recover those fees would not have been futile, they argued. B28-33. They further argued that even if the Reclassification itself was viewed as the transaction challenged by plaintiff, the complaint did not establish demand futility. B34-49.

In opposition to defendants' motion under Rule 23.1, plaintiff agreed with defendants that *Aronson* supplied the governing test for demand futility but argued that the complaint satisfied that test. A96. Plaintiff maintained that the Reclassification, not the fee payments that it sought to recover, was the relevant transaction for the purpose of the demand futility analysis. A97-104.

F. The Court of Chancery dismisses the complaint under Rule 23.1

The Court of Chancery granted defendants' motion under Rule 23.1 and dismissed the complaint.

The court began its analysis with a survey of Delaware case law on demand futility, beginning with *Aronson* v. *Lewis*, 473 A.2d 805 (Del. 1984). Op. 19-42. After completing its survey, the court stated its view that "*Aronson* is broken" and suggested that this Court overrule it and hold that *Rales* v. *Blasband*, 634 A.2d 927 (Del. 1993), sets forth "the general test" for demand futility. Op. 41-42. The court acknowledged that "*Aronson* provides the governing test" for the derivative complaint before it. *Id.* at 42. But, in the court's view, *Aronson*'s "analytical framework [was] not up to the task," while that of *Rales* permitted the court to consider additional alleged conflicts of interest that might excuse demand. *Id.* at 42-43. The court thus decided that it would "appl[y] *Rales*," which "encompasses *Aronson*," and so "dra[w] upon *Aronson*-like principles" in evaluating whether the complaint established demand futility. *Id.* at 41, 43.

The court then conducted "a director-by-director" analysis to determine whether the complaint adequately alleged that a majority of the board was interested in the challenged transaction, faced a substantial likelihood of liability from the derivative complaint, or lacked independence from anyone who either was interested in the challenged transaction or faced a substantial likelihood of

liability from the derivative complaint. *Id.* at 43, 47-64. Even assuming that the challenged transaction was the Reclassification, as plaintiff argued, the court concluded that demand was not futile. *Id.* at 64.

Accordingly, the court found it unnecessary to address defendants' argument that the challenged transactions were in fact the fee payments that plaintiff sought to recover on behalf of the corporation. *Id.* at 44-47. The court also did not address defendants' motion to dismiss the complaint under Rule 12(b)(6).

G. This appeal

On appeal, plaintiff contends that the Court of Chancery erred in holding that the complaint did not adequately plead demand futility. First, plaintiff argues that the court disregarded the second prong of the *Aronson* test and that the complaint established demand futility under that prong. Br. 23-37. In so arguing, plaintiff does not contest the court's holding that the complaint did not plead with particularity bad-faith or otherwise non-exculpated conduct by a majority of the board. Plaintiff also does not contest the court's rejection of its argument that a majority of the board faces a substantial likelihood of liability for the claim asserted in the complaint. Second, plaintiff argues that the complaint established demand futility under the first prong of the *Aronson* test and the court's conclusion to the contrary was incorrect. *Id.* at 38-47.

Plaintiff asks this Court to "reverse" the Court of Chancery's order dismissing the complaint. *Id.* at 1, 47. Plaintiff does not address, however, the two independent arguments for dismissal that defendants raised below and that the Court of Chancery did not reach: (1) that the relevant transactions for the purpose of the demand futility analysis are the fee payments challenged by the complaint, and the complaint does not establish demand futility with respect to claims challenging those transactions, and (2) that the complaint fails to state a claim upon which relief can be granted.

ARGUMENT

I. THE COMPLAINT DOES NOT SATISFY THE SECOND PRONG OF THE *ARONSON* TEST FOR DEMAND FUTILITY

A. Question Presented

Whether the allegations of the complaint established demand futility under the second prong of the test set forth in *Aronson* v. *Lewis*, 473 A.2d 805 (Del. 1984). This issue was raised below and was considered by the Court of Chancery. B32-33, B47-49, B454-60; Op. 43, 49-51, 55-57, 62, 63.

B. Scope of Review

This Court reviews *de novo* the dismissal of a complaint for failure to satisfy the particularized pleading standard of Court of Chancery Rule 23.1. *Brehm* v. *Eisner*, 746 A.2d 244, 253-54 (Del. 2000).

C. Merits of Argument

In *Aronson*, this Court held that a derivative complaint establishes demand futility if, "under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment." 473 A.2d at 814. Plaintiff contends that the Court of Chancery "erased" the second prong of this test from its analysis and so wrongly dismissed the complaint under Rule 23.1. Br. 1. Neither part of plaintiff's argument is correct.

1. The Court of Chancery fully incorporated the second prong of the *Aronson* test into its demand futility analysis

Contrary to plaintiff's assertion, the Court of Chancery did not "eliminat[e] the second prong of *Aronson*." Br. 1. After an exhaustive review of post-*Aronson* case law, the court expressly recognized that "[t]he second prong of *Aronson* remains viable only in the unlikely event that a corporation lacks a Section 102(b)(7) provision, or to the extent that the particularized factual allegations portray a transaction that is so extreme as to suggest bad faith." Op. 35; *see also id.* (recognizing that "exculpation is not available" for "bad faith" conduct). Plaintiff did not contest below—and does not contest in this Court—that Facebook's certificate of incorporation contains a provision under § 102(b)(7) exculpating directors "[t]o the fullest extent permitted by law." B77. Nor has plaintiff at any point disputed that the Court of Chancery may consider such a provision on a motion to dismiss the complaint under Rule 12(b)(6) or Rule 23.1.

Given the undisputed "pleading-stage operation of Section 102(b)(7)," the court stated that its "decision considers"—"on a director-by-director basis"—"whether the complaint pleads particularized facts that support a reasonable inference that the director's decision could be attributed to bad faith." Op. 43-44. The court explained that "[t]his inquiry both recognizes the only situation in which the second prong of *Aronson* has continuing vitality and identifies a scenario in which the pled facts render exculpation unavailable." *Id*. at 44. At the end of this

inquiry, the court determined that the complaint failed to adequately allege bad faith conduct by a majority of the nine directors who would have considered a demand. *See id*. at 49-50 (Zients), 50-51 (Chenault), 55-57 (Hastings), 57 (Thiel), 62-63 (Bowles).

Plaintiff contends that in conducting this inquiry the court improperly "focus[ed] . . . on whether the directors faced a 'substantial likelihood of liability' for approving the challenged transaction." Br. 1. The court, however, merely recognized that where a complaint asserting a breach-of-fiduciary-duty claim does not plead non-exculpated conduct by a majority of the board, it necessarily follows that the complaint does not pose a substantial likelihood of liability for a majority of the board. *See* Op. 33-34 & n.15. By recognizing that corollary, the court did not "eras[e]" the second prong of the *Aronson* test from its analysis.

2. The Court of Chancery correctly concluded that the complaint does not establish demand futility under the second prong of the *Aronson* test

The Court of Chancery's analysis corresponding to the second prong of the *Aronson* test was correct. Plaintiff does not contest on appeal that its complaint fails to allege any bad-faith or otherwise non-exculpated conduct by a majority of the board. Rather, plaintiff insists that a complaint "establishes demand futility under *Aronson*'s second prong by alleging particularized facts creating reason to believe that the board breached its process-based duty of care," regardless of

"whether bad faith or disloyal conduct was alleged." Br. 28. Plaintiff thus contends that its complaint establishes demand futility by pleading conduct by a majority of the board that is fully exculpated and thus poses zero likelihood of liability.

The Court of Chancery properly rejected plaintiff's contention that allegations of exculpated breaches of the duty of care can be sufficient to establish demand futility. Plaintiff acknowledges that "other Court of Chancery decisions" have also rejected that contention. Br. 31-32. That is an understatement. After methodically examining decisions applying the second prong of the *Aronson* test, the Court of Chancery held in *Lenois* v. *Lawal*, 2017 WL 5289611 (Del. Ch. Nov. 7, 2017), that "the weight of this authority" requires particularized allegations of non-exculpated conduct by a majority of the board to establish demand futility. Plaintiff nevertheless contends that "decisions like *Lenois* run counter to the language and purpose of *Aronson*" and should be repudiated by this Court. Br. 32.

As *Lenois* establishes, however, the weight of authority is fully consistent with *Aronson*. *Aronson* itself explained that under longstanding case law, "[t]he rule . . . is that where officers and directors are under an influence which sterilizes their discretion, they cannot be considered proper persons to conduct litigation on behalf of the corporation," and so "demand would be futile." 473 A.2d at 814. Consistent with the rule, the test set forth in *Aronson* was devised to ensure that a

complaint meets the pleading standard of Rule 23.1 only when it identifies "an influence" that compromises the board's ability "to conduct litigation on behalf of the corporation." *Id.* at 814-15; *see also Lenois*, 2017 WL 5289611, at *14 ("[t]he purpose of the demand futility analysis . . . is to determine whether the board tasked with considering demand could bring its business judgment to bear"). Accordingly, "[t]he Court removes the demand decision from the board where the complaint pleads facts as to individual directors showing that a majority of them cannot consider demand impartially." *Lenois*, 2017 WL 5289611, at *14.

Aronson predated § 102(b)(7), and so at the time it was issued, directors generally were exposed to liability for breaches of the duty of care. After the enactment of § 102(b)(7), however, and in particular after this Court's confirmation that exculpation provisions in corporate charters are cognizable on motions to dismiss a complaint, *see In re Cornerstone Therapeutics Inc. S'holder Litig.*, 115 A.3d 1173, 1175-76 (Del. 2015), the weight of Chancery authority recognized that such provisions properly affect the demand futility analysis as contemplated by *Aronson*. *See* Op. 31-35 (reviewing case law); *Lenois*, 2017 WL 5289611, at *9-14 (same). After all, *Aronson* itself cautioned that "the mere threat of personal liability for approving a questioned transaction, standing alone, is insufficient to challenge either the independence or disinterestedness of directors, although in rare cases a transaction may be so egregious on its face that board

approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists." 473 A.2d at 815.

Plaintiff insists that this passage from *Aronson* pertains only to the first prong of the *Aronson* test. But the decision itself nowhere says that. And the Court of Chancery and this Court have read that passage to relate to the second prong of the *Aronson* test. For example, in *Guttman* v. *Huang*, 823 A.2d 492, 500 & n.15 (Del. Ch. 2003), the court cited this passage in explaining that "the second prong of *Aronson*" is "a safety valve that releases a suit for prosecution when . . . the threat of liability to the directors required to act on the demand is sufficiently substantial to cast a reasonable doubt over their impartiality." (citing *Aronson*, 473 A.2d at 815). In *Lenois*, the Court again read the passage to articulate when "demand may be futile under the second prong." 2017 WL 5289611, at *14 (citing *Aronson*, 473 A.2d at 815). And in *Wood* v. *Baum*, 953 A.2d 136, 140, 141 (Del. 2008), a demand futility case that "implicated" only the second prong of *Aronson*, this Court confirmed that "a serious threat of liability may only be found to exist if the plaintiff pleads a *non-exculpated* claim against the directors based on particularized facts." (quoting *Guttman*, 823 A.2d at 501).

Plaintiff suggests that allegations of exculpated conduct can be enough to establish demand futility where the complaint challenges a transaction subject to entire fairness review. Br. 32-34. But "[a] plaintiff seeking only monetary

damages must plead non-exculpated claims against a director who is protected by an exculpatory charter provision to survive a motion to dismiss, regardless of the underlying standard of review." *In re Cornerstone*, 115 A.3d at 1175. A derivative complaint challenging a transaction subject to entire fairness review thus does not necessarily threaten a majority of the board with a substantial likelihood of liability and so risk compromising the directors' impartial business judgment. Delaware courts therefore "do not find demand excused simply because the proper standard of review is entire fairness." *Lenois*, 2017 WL 5289611, at *13 n.103; *see also Teamsters Union 25 Health Servs. & Ins. Plan* v. *Baiera*, 119 A.3d 44, 65 (Del. Ch. 2015).

Plaintiff cites a handful of cases that it says support its view that allegations of exculpated directorial conduct can establish demand futility under the second prong of the *Aronson* test. Most of those cases hold no such thing. In *Brehm*, this Court did not consider the effect of an exculpation provision on the proper analysis under *Aronson*. 746 A.2d 244. It therefore did not hold—and could not have held—that a plaintiff can rely on allegations of exculpated conduct to establish demand futility. *In re Walt Disney Company Derivative Litigation*, 825 A.2d 275 (Del. Ch. 2003), another decision in the same litigation, also did not hold that allegations of exculpated conduct could establish demand futility where the board was protected by an exculpation provision. To the contrary, the court held that the

complaint established demand futility by adequately alleging "acts or omissions not undertaken honestly and in good faith," which "do not fall within the protective ambit of § 102(b)(7)." *Id.* at 286. And in *H&N Management Group, Inc.* v. *Couch*, 2017 WL 3500245, at *1 (Del. Ch. Aug. 1, 2017), the court held that the complaint established demand futility by alleging non-exculpated conduct—specifically, gross negligence, where "the relevant exculpation provision does not protect the board from liability for gross negligence."

Plaintiff identifies only one case in which the court held that a complaint established demand futility by pleading exculpated conduct: *McPadden* v. *Sidhu*, 964 A.2d 1262 (Del. Ch. 2008). The Court of Chancery, however, has repeatedly declined to follow that decision. *See, e.g.*, *Lenois*, 2017 WL 5289611, at *12-13 (discussing *McPadden* at length before rejecting its approach in favor of that taken by the "weight of authority"); *Ryan* v. *Armstrong*, 2017 WL 2062902, at *17 & n.166 (Del. Ch. May 15, 2017), *aff'd*, 176 A.3d 1274 (Del. 2017); *see also* Op. 30 n.13.

These decisions refusing to follow *McPadden* are well-grounded in this Court's *Aronson* decision. In *McPadden*, the plaintiff asserted claims of breach of the duty of care against a corporation's eight directors and one former officer. 964 A.2d at 1263-64. The plaintiff did not contest the independence or disinterestedness of any director. *Id.* at 1270. Although the directors were

protected by an exculpation provision, the court treated that provision as irrelevant to the Rule 23.1 analysis. *Id.* at 1270-73. The court concluded that the complaint established demand futility under the second prong of the *Aronson* test by pleading with particularity breaches of the duty of care by all defendants. *Id.* at 1270. The court then conducted a separate analysis under Rule 12(b)(6) and dismissed the claims against the directors on the basis of the exculpation provision, but sustained the claim against the officer, who was not protected by the exculpation provision. *Id.* at 1273-77. The result was that the board's authority to decide whether to sue the former officer was displaced even though the plaintiff had pleaded no reason to doubt the board's ability to impartially consider a demand in the best interests of the corporation. That result cannot be reconciled with the board's default authority over the business and affairs of the corporation, including any potential legal claims, and *Aronson*'s own articulation of the demand futility rule.[1]

Plaintiff nevertheless argues that this Court should endorse *McPadden* and reject the overwhelming weight of authority on the proper application of the

[1] In any event, the allegations here are not at all like those in *McPadden*, in which the board allegedly "provid[ed] no check" on an officer's purchase of a company subsidiary. 964 A.2d at 1271-72. By contrast, the Facebook board formed a Special Committee to negotiate and respond to Zuckerberg's proposal for a reclassification. A26-27, A35. Moreover, the *McPadden* court dismissed claims against all defendants except the self-dealing officer. 964 A.2d at 1277. But here there was not and could not have been any self-dealing because (among other reasons) the Reclassification never took effect.

second prong of *Aronson*. Otherwise, plaintiff contends, the *Aronson* test will "undermine shareholder rights," "weaken accountability" of directors, and allow controlling stockholder transactions to evade "meaningful judicial review." Br. 35-36. That contention lacks merit.

A stockholder has no general right to control corporate claims—that right belongs to the board, unless the stockholder "can articulate a reasonable basis to be entrusted with a claim that belongs to the corporation." *Brehm*, 746 A.2d at 255. Enforcing the demand requirement where a stockholder has alleged only exculpated conduct by the directors, and thus no basis to displace their authority over corporate claims, does not "undermine shareholder rights." Br. 35. To the contrary, it respects the authority of the board elected by the stockholder body. Nor does it immunize directors and controlling stockholders from claims that their breaches of fiduciary duty have harmed the corporation. Rather, it simply leaves control over such claims in the hands of a board of directors capable of properly addressing them as a matter of law.

Plaintiff thus identifies no basis to reverse the Court of Chancery's dismissal of its derivative complaint. Defendants do not dispute that the Court of Chancery chose not to apply the *Aronson* test, as originally formulated by this Court. But, as demonstrated above, any error the court may have committed by doing so was harmless because the actual analysis the court undertook directly tracked both

prongs of the *Aronson* test. It is telling that plaintiff's main contention of error is not that the court applied the *Rales* test, but that the court followed the weight of authority in interpreting the inquiry called for by the second prong of the *Aronson* test.

It is of course the prerogative of this Court to determine if and when to reconsider *Aronson*. But given the Court of Chancery's functional and correct application of the *Aronson* test, an affirmance would not require this Court to disturb any of its prior decisions.

II. THE COMPLAINT DOES NOT SATISFY THE FIRST PRONG OF THE *ARONSON* TEST FOR DEMAND FUTILITY

A. Question Presented

Whether the allegations of the complaint established demand futility under the first prong of the test set forth in *Aronson* v. *Lewis*, 473 A.2d 805 (Del. 1984). This issue was raised below and was considered by the Court of Chancery. B28-32, B35-47, B460-67; Op. 35, 47-64.

B. Scope of Review

This Court reviews *de novo* the dismissal of a complaint for failure to satisfy the particularized pleading standard of Court of Chancery Rule 23.1. *Brehm*, 746 A.2d at 253-54.

C. Merits of Argument

A complaint satisfies the first prong of the *Aronson* test for demand futility only if, "under the particularized facts alleged, a reasonable doubt is created that . . . the directors are disinterested and independent." *Aronson*, 473 A.2d at 814. The Court of Chancery held that the complaint did not plead with particularity that a majority of the nine-member board—Zients, Chenault, Hastings, Thiel, and Bowles—was not disinterested and independent with respect to the Reclassification. Op. 49-64.

Plaintiff does not contest the court's holding that the complaint failed to plead that a majority of the board was interested in the Reclassification. Br. 6-7,

38. Nor does plaintiff contest the court's ruling that the complaint did not call into question the independence of either Zients or Chenault. *Id.* at 38. Rather, plaintiff contends that the Court erred in holding the complaint did not adequately plead that Hastings, Thiel, and Bowles were not independent of Zuckerberg. *Id.* at 40-41, 43-47. That holding, however, was correct. The complaint does not plead with particularity reasons why these three directors could not impartially consider a demand in the best interests of the corporation.

1. The complaint does not plead reason to doubt the independence of Hastings

Plaintiff contends that the complaint adequately challenged the independence of Hastings, the CEO of Netflix, by alleging that he is "biased in favor of founders maintaining control of their companies," that his "philanthropy" is "interconnected" with Zuckerberg's, and that Facebook and Netflix "have a business relationship." *Id.* at 46. But as the Court of Chancery held, these allegations "fai[l] to . . . suppor[t] a reasonable inference that Hastings is beholden to Zuckerberg." Op. 52; *see also* B42-44, B465-66.

To begin with, the complaint does not allege any facts supporting the conclusory allegation that Hastings, who founded Netflix but owns only 2% of its outstanding stock, is "biased" in favor of founder control. In any event, a director's belief that "it is generally optimal for companies to be controlled by their founders and that this governance structure is value-maximizing . . . would not

produce a conflict of interest that would render him incapable of considering a demand." Op. 53-54. As the Court of Chancery recognized, "[a]s long as an otherwise independent and disinterested director has a rational basis for her belief, that director is entitled (indeed obligated) to make decisions in good faith based on what she subjectively believes will maximize the long-term value of the corporation." Op. 53.

As for the allegation that both Hastings and Zuckerberg have made large donations to the Silicon Valley Community Foundation, "[t]here is no logical reason to think that a shared interest in philanthropy would undercut Hastings' independence," Op. 54—and plaintiff does not explain how it would. There is likewise no logical reason why "donating to the same charitable fund would result in Hastings feeling obligated to serve Zuckerberg's interests." *Id.*

Plaintiff contends that this "mutual affiliatio[n]" would compromise Hastings' ability to impartially consider a demand. Br. 46-47. But an allegation that Hastings and Zuckerberg donated to the same foundation—in the area where they both live and work—does not support the inference that Hastings "would be more willing to risk [his] reputation than risk [his] relationship with [Zuckerberg]." *Beam ex rel. Martha Stewart Living Omnimedia, Inc.* v. *Stewart*, 845 A.2d 1040, 1052 (Del. 2004). Moreover, the facts of the case on which plaintiff relies bear no resemblance to those alleged here. *See In re Oracle Corp. Deriv. Litig.*, 824 A.2d

917, 943 (Del. Ch. 2003) (finding that a professor serving on a special litigation committee would be reluctant to authorize suit against his former teacher and fellow professor at the same university).

The allegation that Netflix and Facebook "have a business relationship" is unaccompanied by any allegations "support[ing] an inference that the relationship is sufficiently material to Netflix that it would compromise Hastings' ability to consider a demand" impartially. Op. 53. The complaint nowhere alleges "specific facts" about "how valuable this relationship is to Netflix" or even "whether Netflix has realized any concrete advantages" from it. *Id.* Indeed, Facebook's 2019 annual proxy filing makes clear that Netflix purchased advertising from Facebook "in the ordinary course of business pursuant to [Facebook's] standard terms and conditions, including through a competitive bid auction." B119-20.

"[T]he Court has no grounds to question [a director's] independence based on [a business] relationship" where plaintiff has "not even attempted to plead [its] materiality." *In re Martha Stewart Living Omnimedia, Inc. S'holder Litig.*, 2017 WL 3568089, at *20 (Del. Ch. Aug. 18, 2017); *see also Kahn* v. *M & F Worldwide Corp.*, 88 A.3d 635, 649 (Del. 2014) ("Consistent with [the] predicate materiality requirement, the existence of some financial ties between the interested party and the director, without more, is not disqualifying.").

Plaintiff also suggests that Hastings (and the rest of the directors on the Facebook board) are not entitled to a presumption of independence because Facebook is a controlled company. Br. 38-40. But that argument was rejected in *Aronson* itself, in which the challenged transaction was between the corporation and its controlling stockholder. 473 A.2d at 808, 816 ("[I]t is not enough to charge that a director was nominated by or elected at the behest of those controlling the outcome of a corporate election. That is the usual way a person becomes a corporate director.").

2. The complaint does not plead reason to doubt the independence of Thiel

Plaintiff contends that the complaint successfully challenged Thiel's independence by alleging "an abundance of ties with Zuckerberg" and that the Court of Chancery improperly disregarded the significance of those ties. Br. 44-45. The court, however, properly tested the alleged ties for materiality and found them wanting. For a director's alleged "ties" to an interested person to be material, they must be "sufficiently substantial that he or she could not objectively discharge his or her fiduciary duties." *M & F Worldwide*, 88 A.3d at 649. And under Rule 23.1, facts showing alleged ties to be material must be pleaded with particularity.

Plaintiff points to its allegations that Thiel was "one of the early investors in Facebook" and is the company's "longest-tenured Board member besides Zuckerberg." Br. 44. But as the court recognized, "[t]he complaint does not

explain how Thiel's longstanding affiliation with Facebook or his instrumental contributions to Facebook translate into Thiel being beholden to Zuckerberg." Op. 58. Plaintiff also invokes its conclusory allegation that a venture capital firm Thiel co-founded "gets good deal flow" from his association with Facebook. Br. 44. But as the court also recognized, the complaint "does not identify a single deal that has flowed to the Founders Fund as a result of Thiel's relationship with Facebook, still less that any such deal was material to Thiel or the Founders Fund." Op. 59.

Plaintiff argues that these allegations show that Thiel "greatly benefited" from "his seat on Facebook's board" and so was not independent of Zuckerberg. Br. 44. In concluding otherwise, plaintiff maintains, the court "focus[ed] . . . too narrow[ly]" on "whether Thiel's board seat is 'financially material' to him" and should have also examined whether losing the seat would result "in a loss of standing" given "social norms." *Id.* at 44, 45. But that is exactly what the court did. The court did not hold only that "[t]he complaint does not support an inference that Thiel's service on the Board is financially material to him"—a holding plaintiff does not contest. Op. 60. The court continued: "Nor does the complaint sufficiently allege that serving as a Facebook director confers such cachet that Thiel's independence is compromised." *Id.*

Plaintiff also relies on its allegation that Thiel, supposedly like Hastings, could not act independently of Zuckerberg because he is an advocate of founder

control. Br. 44. That allegation fails to support an inference that Thiel is not independent for the same reasons it fails to support an inference that Hastings is not independent. *See supra* 31-32; Op. 58-59.

3. The complaint does not plead reason to doubt the independence of Bowles

Plaintiff contends that the complaint also successfully challenged Bowles' independence from Zuckerberg. Br. 40-41, 43. But the Court of Chancery was correct in concluding that the allegations of the complaint do not plead with particularity facts supporting an inference that Bowles was not independent.

Plaintiff first argues that "governance failures" by the Special Committee that considered the Reclassification, on which Bowles served, "demonstrat[e]" that the Committee's members were beholden to Zuckerberg. *Id.* at 40-41. These alleged "governance failures" consist of plaintiff's criticisms that the Special Committee did not effectively negotiate with Zuckerberg to obtain what it viewed as a superior alternative to the Reclassification. *See id.* at 12-19. But a plaintiff's "criticism of [a] Special Committee for not evaluating alternative transactions"—let alone obtaining them—"does not implicate director self-interest or lack of independence." *In re Alloy, Inc. S'holder Litig.*, 2011 WL 4863716, at *8 (Del. Ch. Oct. 13, 2011). "Even if supported by well-pleaded facts, such a criticism would state at best a claim for breach of the duty of care." *Id.*; *see also In re CompuCom Sys., Inc. S'holders Litig.*, 2005 WL 2481325, at *9 (Del. Ch. Sept. 29,

2005) (the "independence or not of [a] member of a special committee is a question of fact that turns . . . upon the reality of the interests and incentives affecting the independent directors" (internal quotation marks omitted)). While the complaint second-guesses the Special Committee's negotiation efforts, it does not allege any facts suggesting that Bowles acted in "a controlled mindset," Br. 41. To the contrary, the complaint singles out Bowles for resisting some of the terms Zuckerberg sought. A42. As the Court of Chancery observed, "[t]he fact that Bowles voiced concerns suggests that he acted independently, not the opposite." Op. 63.

Plaintiff also contends that Bowles demonstrated his lack of independence when he told Zuckerberg that he was "proud to be a small part of your life." Br. 43; A33. The occasion of that remark: learning of Zuckerberg's pledge to give away the majority of his wealth during his lifetime. As the trial court observed, this allegation merely "suggest[s] that Zuckerberg and Bowles had a collegial relationship," not "that Bowles was beholden to Zuckerberg." Op. 61; *see Beam*, 845 A.2d at 1051 ("collegial relationships among the board of directors" do not undermine presumption of independence).

Plaintiff argues that Bowles "used the committee process to advance his personal relationships with Evercore and Morgan Stanley." Br. 43. But the complaint does not explain how this allegation supports an inference that Bowles

did or would prioritize Zuckerberg's interests over Facebook's. In any event, the allegation is unsupported by any particularized allegations of fact. The complaint alleges only that Bowles was once a director of Morgan Stanley and is a "close friend" of an Evercore banker. A57. For a director to be considered interested in a transaction, he or she must "expect to derive [] personal financial benefit from it" and that benefit "must be alleged to be *material* to that director." *Orman* v. *Cullman*, 794 A.2d 5, 23 (Del. Ch. 2002). The complaint does not plead that Bowles received any financial benefit as a result of the fees paid to Morgan Stanley or Evercore, let alone a material amount. Nor does it plead anything elaborating on Bowles's friendship with the Evercore banker. *See M & F Worldwide*, 88 A.3d at 649 ("Bare allegations that directors are friendly with … the person they are investigating are not enough to rebut the presumption of independence."). Thus, as the Court of Chancery found, plaintiff's allegations "do not support a reasonable inference that Bowles received any material personal benefit, financial or otherwise, either from Facebook's retention of Morgan Stanley or the Committee's retention of Evercore." Op. 61.

4. The complaint does not plead reason to doubt the independence of Desmond-Hellmann

The Court of Chancery did not address whether the complaint adequately pleaded that Desmond-Hellman was not independent of Zuckerberg because it concluded that at least five other members of the demand board could evaluate a

demand. This Court need not consider this issue for the same reason. Plaintiff, however, invites this Court to reach that issue in the first instance.

Plaintiff contends first that it adequately pleaded Desmond-Hellmann's lack of independence by alleging "governance failures" by the Special Committee. That argument fails for the same reasons it fails with respect to Bowles.

Plaintiff also contends that the complaint successfully challenges Desmond-Hellmann's independence because it alleges that "the Gates Foundation would benefit by future joint collaborations with CZI [the Chan-Zuckerberg Initiative]" and so Zuckerberg's philanthropy "redounded to [her] professional benefit." Br. 41-42. But as defendants explained below, the complaint contains no particularized allegations regarding any future joint collaborations, or even how any hypothetical collaborations would benefit Desmond-Hellmann, let alone materially so. B39-40.

To raise a reasonable doubt by virtue of business dealings, a plaintiff must plead with particularity that a director's business relationship, or hypothetical future relationship, with an interested party is material to the director. *See, e.g., In re Goldman Sachs Grp., Inc. S'holder Litig.*, 2011 WL 4826104, at *11 (Del. Ch. Oct. 12, 2011) (rejecting attack on director for failure to plead materiality of business relationship); *Beam*, 845 A.2d at 1050. Here, the complaint alleges no facts explaining the importance of the relationship between Zuckerberg and the

Gates Foundation; no facts about how that relationship may bear on Desmond-Hellmann's career; and no facts to suggest that the Gates Foundation—an entity with an endowment in excess of $40 billion—relies on Zuckerberg for funding or programmatic initiatives or anything else. B39-40, B463-65. In the absence of any allegations of materiality, the assertion that the Zuckerberg-Gates Foundation connection disables Desmond-Hellmann's independence fails as a matter of law.

Plaintiff's only remaining allegation is that Desmond-Hellmann, in her former role as president of the University of California at San Francisco, successfully "cultivated Zuckerberg as a major donor." A28. But there are no allegations that Desmond-Hellmann herself received any kind of benefit from this, as defendants have explained. *See* B41. And the only specific allegation is that Zuckerberg donated $5 million to the UCSF Children's Hospital sometime in 2009. A28. The complaint does not allege that Desmond-Hellmann solicited it, or that it was important to the university or Desmond-Hellmann personally, or anything establishing a relationship between it and Desmond-Hellmann's decision-making as a Facebook director. *See* B41; *In re Goldman Sachs*, 2011 WL 4826104, at *9-10 (rejecting attacks on independence due to philanthropic contributions where complaint fails to "mention the materiality of" the donations or "how the amounts given influenced [the director's] decision-making process").

CONCLUSION

For the foregoing reasons, the Court of Chancery's order dismissing the complaint should be affirmed.

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