Delaware Court of Chancery Holds That Demand Futility May Be Pleaded With Less "Particularity" Than a Standard Fraud Claim Under Rule 9(b)

Delaware law is clear that a shareholder generally may not bring a derivative action on behalf of a corporation unless the shareholder pleads that: (i) it made a pre-litigation demand upon the board of directors of the corporation or (ii) such demand upon the board would have been futile. *See* Del. Ct. Ch. R. 23.1. Rule 23.1, which is modeled after Fed. R. Civ. P. 23.1, requires that these predicate facts must be "allege[d] with particularity," which is a higher standard than typical notice pleading under Rule 8(a).

The Delaware Chancery Court's recent decision in *Elburn* v. *Albanese*, C.A. No. 2019-0774-JRS, 2020 WL 1929169 (Del. Ch. Apr. 21, 2020), squarely addressed for the first time "what is required to plead a fact 'with particularity' under Rule 23.1." *Id.* at *2. Relying primarily upon federal decisions construing the particularity requirement of Fed. R. Civ. P. 9(b) in the context of fraudulent omission cases, the Court found that Rule 23.1 does not require the pleading of classic "newspaper facts" — i.e., the "'who, what, when, where and how' concerning the alleged fiduciary wrongdoing" — to allege demand futility adequately. *Id.* at *8, *8 n. 95. Accordingly, the Court allowed the claim in *Elburn* to proceed, despite the fact that the plaintiff "has not identified the specific discussions that comprised the [allegedly wrongful] agreement"; the plaintiff merely "described the agreement 'with detail sufficient to apprise the defendant of the basis for the claim,'" which the court deemed sufficient. *Id.* at *3.

I. Background

Investors Bancorp ("Bancorp") is a Delaware holding company for Investors Bank, a New Jersey chartered savings bank. In 2015, Bancorp stockholders approved an equity incentive plan ("EIP") adopted by Bancorp's board of directors (the "Board"). Following the approval, Board members granted themselves substantial stock options and restricted stock units under the EIP (the "2015 Awards"). Bancorp's CEO, Kevin Cummings ("Cummings"), and President/COO, Domenick Cama ("Cama"), were the largest beneficiaries of the 2015 Awards.

In 2016, Robert Elburn ("Elburn") commenced a derivative action, alleging that the Board had breached its fiduciary duties by approving the 2015 Awards. Elburn sought rescission of the 2015 Awards, including the substantial amounts awarded to Cummings ($16.7 million) and Cama ($13.4 million). The case was settled before trial. Cummings and Cama agreed to forfeit the entirety of their awards, and Chancery Court approved the settlement in June 2019.

Bancorp filed a proxy statement for its 2019 annual stockholders meeting in April of 2019. The statement informed stockholders that the Board "intended to consider the issuance of new awards to Cummings and Cama under the previously approved EIP" ("Replacement Awards"). *Id.* at *1. The Replacement Awards took effect in July 2019 after approval of the settlement of the original derivative action and granted Cummings and Cama awards "similar in scope" to their 2015 Awards. *Id.*

Elburn commenced a new derivative litigation that sought to rescind the Replacement Awards. Elburn alleged that the Replacement Awards were part of a broader *quid pro quo* between nonemployee board members on one hand, and Cummings and Cama on the other. According to Elburn, the Replacement Awards enabled the defendants "in the 2016 [derivative action] to settle the claims against them by appearing to agree to substantial concessions when, in fact, Cummings and Cama gave up very little." *Id.*

Defendants moved to dismiss the second derivative action, arguing that Elburn did not satisfy the exacting standards of Rule 23.1 for pleading demand futility. Defendants urged the Chancery Court to "construe the 'with

particularity' language in Rule 23.1 just as it construes the same language in Rule 9(b). That is, the court should require Plaintiff to support his demand futility allegations with the so-called 'newspaper facts' — who, what, when, where and how — just as the court requires of plaintiffs who attempt to plead fraud." *Id.* at *2.

II. The Delaware Chancery Court Rejects Defendants' Argument

The Chancery Court began its analysis by observing that Defendants and Elburn fundamentally disagreed about the "degree of particularity" required by Rule 23.1. Defendants pressed for application of Rule 9(b)'s heightened standard of particularity, while Elburn argued that "unlike a plaintiff alleging fraud, who is likely a witness to (if not the recipient of) the fraudulent overture, the derivative stockholder plaintiff rarely, if ever, is witness to, or has direct knowledge of, the breaches of fiduciary duty he alleges in his complaint." *Id.* at *2. Given the wide chasm between the parties' positions, the Court deemed it appropriate "to dilate on Rule 23.1's 'with particularity' pleading standard" (*id.* at *7) before eventually adopting what the Court stated were the less rigorous Rule 9(b) pleading requirements typically applied in cases concerning fraudulent omissions — i.e., requiring some degree of "particularity," but dispensing with the need to plead all of the "newspaper facts."

The Chancery Court commenced its analysis by observing that Delaware courts typically require different degrees of adherence to Rule 9(b)'s particularity requirement depending upon the context of the particular case. According to the Court, "nothing in [Delaware's] Rule 9(b), or the cases interpreting the rule, say that newspaper facts must be pled in every fraud case, come what may." *Id.* at *3. Citing to *LVI Gp. Invs., LLC* v. *NCM Gp. Hldgs. LLC*, 2017 WL 1174438 (Del. Ch. Mar. 29, 2017), the Court reasoned that Rule 9(b) requires "only that 'a plaintiff [] allege the circumstances [of the fraud] with detail sufficient to apprise the defendant of the basis for the claim." *Elburn*, 2020 WL 1929169, at *3; *see also id.* ("While newspaper facts *often* will be necessary to meet this standard in the fraud context, the lack of this 'specificity' when pleading either fraud or demand futility is not, *de jure*, 'fatal' to the claim."). The Court stated explicitly that he saw no reason to "depart from, or enhance" the standard used by Delaware courts in the context of Rule 9(b). *Id.*

The Chancery Court then analyzed what degree of particularity was required for Elburn to plead demand futility, invoking public policy considerations to observe that the "rationale for requiring a plaintiff to plead newspaper facts describing an alleged fraud under Rule 9(b) falls away, however, when a stockholder attempts to plead a derivative breach of fiduciary claim under Rule 23.1." *Id.* at *8. The Court distinguished between a fraud plaintiff — "who was likely a witness to (if not the recipient of) the fraudulent overture" and thus "is witness to, or has direct knowledge" of. the facts necessary to plead fraud with particularity[1] (*id.* at *2, *8) — and shareholders, who are not present at board meetings, often are not privy to board discussions, and "[e]ven with Section 220"

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[1] The Chancery Court's decision to characterize fraud plaintiffs as present for, and thus aware of, the particular newspaper facts supporting a claim for fraud is noteworthy. The apparent basis for this conclusion is the line of Delaware cases finding that, where "a plaintiff's claim for fraud is based on a written contractual representation, it is relatively easy [for a plaintiff] to plead a particularized claim of fraud. In such a situation, the plaintiff can readily identify who made what representations where and when [and] what the defendant gained, which was to induce the plaintiff to enter into the contract." *LVI Grp. Invs., LLC* v. *NCM Gp. Hldgs. LLC*, 2017 WL 1174438, at *4 (Del. Ch. Mar. 29, 2017) (citations and quotation marks omitted). Numerous courts interpreting and applying the analogous Fed. R. Civ. P. 9(b) have reached the divergent conclusion that, "[p]articularly in cases of corporate fraud, plaintiffs cannot be expected to have personal knowledge of the details of corporate internal affairs." *Craftmatic Sec. Litig.* v. *Kraftsow*, 890 F.2d 628, 645 (3d Cir. 1989); *see also Wexner* v. *First Manhattan Co.*, 902 F.2d 169, 172 (2d Cir. 1990) ("Despite the general rigid requirement that fraud be pleaded with particularity, the allegations may be based on information and belief when facts are peculiarly within the opposing party's knowledge.") (citations omitted). As detailed herein, courts faced with such fraud claims have articulated a balancing of Rule 9(b)'s requirement to ensure claims do not proceed on mere speculation and conclusions.

books and records request "documents in hand . . . would be hard pressed to plead . . . 'who, what, when, where and how' facts about fiduciary wrongdoing." *Id.* at *8.

Based on the distinction between fraud plaintiffs and shareholders proceeding derivatively, the Chancery Court decided the more appropriate lens through which to evaluate demand futility is that deployed by federal courts when considering fraudulent omission claims. *See id.* at *8 ("In my view, the better paradigm in which to assess particularity in the Rule 23.1 context is the one in which courts contextually evaluate allegations of fraudulent omissions. Where the plaintiff alleges fraud by omission, courts generally 'relax Rule 9(b)'s fraud pleading requirement.'").[2] The Court reached this determination, despite acknowledging that "derivative plaintiffs frequently seek to hold fiduciaries liable for their actions, not their omissions." *Id.* This difference is significant because Rule 9(b) is relaxed in omission cases specifically because "a plaintiff cannot plead either the specific time of [an] omission or the place, as he is not alleging an act, but a failure to act." *Ashgari* v. *Volkswagen Grp. of Am., Inc.*, 42 F. Supp. 3d 1306, 1325 (C.D. Cal. 2013).

Applying this framework to the case at hand, the Chancery Court concluded that Elburn "plainly describe[d] the specific misconduct in which each Defendant is alleged to have participated and the bases upon which Plaintiff alleges that an illicit *quid pro quo* arrangement led to the Replacement Awards." *Id.* at *9. The Court was swayed particularly by the allegations found at Paragraph 100 of the Complaint, which alleged:

> As described above, each of these directors were able to retain a substantial portion of their challenged awards *only* because Cummings and Cama had agreed to forfeit *all* of their awards as part of the Settlement. As it turned out, Cummings and Cama's agreement came with strings attached: *Before Agreeing to the Settlement*, Cummings and [Cama] sought, and received, an undisclosed assurance from the Board's non-employee directors that they would 'replace' the awards Cummings and Cama were agreeing to give up, in an amount acceptable to Cummings and Cama.

While not a dispositive factor, it is worth observing that the Chancery Court appeared to consider that "[t]argeted discovery is likely to reveal *rather quickly* if the *quid pro quo* agreement alleged in the Complaint was actually reached." *Id.* (emphasis added). Given the stated concerns that shareholders are at an informational disadvantage *vis-à-vis* board members, it appears that the Court in essence balanced the costs of targeted discovery against the costs of imposing too high a standard for pleading the requisite demand futility.

It also is worth noting that federal decisions applying a relaxed standard pursuant to Rule 9(b) typically require the pleading of something more to ensure that fraud claims do not proceed based upon mere speculation and conclusion. For example, the Court of Appeals for the Third Circuit — along with numerous other federal appellate courts — has found repeatedly that the relaxation of Rule 9(b) is not license to dispense with the pleading of particular facts. *See, e.g.*, *Craftmatic Sec. Litig.* v. *Kraftsow*, 890 F.2d 628, 645-46 (3d Cir. 1989) ("[C]ourts have relaxed [Rule 9(b)] when factual information is peculiarly within the defendant's knowledge or control. . . . Nonetheless, even under a non-restrictive application of the rule, pleaders must allege that the necessary information lies within defendant's control, and their allegations must be accompanied by a statement of the facts upon which

[2] The Chancery Court cited *JP Morgan Chase Bank, N.A.* v. *Ballard*, 213 A.3d 1211, 1245 n.201 (Del. Ch. 2019) (quoting Wright & Miller § 1298), as support for this proposition. The referenced footnote from the decision, however, cites to Wright and Miller for the proposition that "under Fed. R. Civ. P. 9(b), which is identical to Del. Ch. Ct. R. 9(b), 'courts may relax Rule 9(b)'s fraud pleading requirement if the defendant *is alleged to have concealed* the facts that would permit the plaintiff to plead fraud with particularity'") (emphasis added). The key requirement of this provision is that the relaxation of Rule 9(b)'s requirements must be accompanied by pleading of concealment by the defendant.

the allegations are based. . . . [P]laintiffs must accompany their allegations with facts indicating why the charges against defendants are not baseless and why additional information lies exclusively within defendants' control.") (citations omitted).[3] The Chancery Court in *Elburn* appears to have focused more upon whether the allegations put the defendants on notice of the challenged conduct, rather than whether the claims were supported by adequate facts establishing the elements of the claim or why a relaxed pleading standard should be applied.

III. Implications

The *Elburn* decision, if more widely adopted in cases before the Court of Chancery, could lead to an increased number of shareholder derivative actions surviving a motion to dismiss in Delaware courts. Relatedly, shareholders of Delaware corporations may be emboldened to forgo demands upon a company's board, choosing instead to plead demand futility as the *de facto* norm. It will be interesting to see how *Elburn's* rationale is received by the Delaware Bar and the Chancery Court more generally, given some of the analytical reasoning employed by the Court in *Elburn*, including its reliance on federal omissions cases and its conclusion that fraud plaintiffs are typically witnesses to the fraud. Delaware corporations should monitor the progress of this case through any subsequent appeals and be watchful for the invocation of *Elburn's* analysis by other members of the Chancery Court in future cases.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email authors Joel Kurtzberg at 212.701.3120 or jkurtzberg@cahill.com; or Peter J. Linken at 212.701.3715 or plinken@cahill.com; or email publications@cahill.com.

[3] *See also Wexner* v. *First Manhattan Co.*, 902 F.2d 169, 172 (2d Cir. 1990) ("This exception to the general rule must not be mistaken for license to base claims of fraud on speculation and conclusory allegations. Where pleading is permitted on information and belief, a complaint must adduce specific facts supporting a strong inference of fraud or it will not satisfy even a relaxed pleading standard.").

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