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Delaware Supreme Court Decision on Director Independence Suggests to Some a Change in the Court's Recent Approach– McElrath v. Kalanick

In *McElrath v. Kalanick* (Jan. 13, 2020), the Delaware Supreme Court upheld the Court of Chancery's decision that dismissed a derivative suit brought by a stockholder of Uber Technologies, Inc. ("Uber") for damages arising from Uber's 2016 acquisition of Ottomotto LLC ("Otto"). The Supreme Court agreed with the Court of Chancery's determination that a majority of the Uber directors in office at the time the complaint was filed were independent and had not acted in bad faith–and, therefore, that pre-suit demand on the board to bring the litigation would not have been "futile" and so was not excused.

Key Point

- **The decision, in our view, does not necessarily suggest a change in the Delaware courts' recent approach in determining director independence in the demand futility context.** Delaware has consistently applied long-established principles for determining director independence. In recent years, however, when applying those principles in the demand futility context, the courts have appeared to more readily find non-independence than they had previously. Some commentators have suggested that the decision signals a return to the seemingly stronger presumption of independence of the past. While that is possible, we do not read the decision that way (as discussed below).

- **Separately, the decision reinforces that there continues to be a high bar to a finding of bad faith by directors**–and that this, in combination with exculpation provisions, continues to make it highly unlikely that independent directors would have personal liability for alleged fiduciary breaches except in the most egregious cases.

Background. The plaintiff's complaint alleged (and, at the pleading stage, the Supreme Court was required to accept as true) the following: In 2015, Uber's founder and then-CEO, Travis Kalanick, began to recruit the then-Engineering Manager of Google Inc.'s autonomous vehicle program, "AL," to leave Google and join Uber. Kalanick and AL "communicated extensively" and became personally "very close." In late January, 2016, AL and over a dozen Google employees left Google to work at Ottomotto LLC ("Otto"), which AL had founded two weeks earlier. Shortly thereafter, Uber and Otto signed a term sheet for Uber to acquire Otto. Otto had no real operations and was run from AL's house; Uber paid only $100,000 upfront to acquire it. Thus, the plaintiff alleged, the acquisition was essentially for the purpose of hiring AL and his team–indeed, he contended, the acquisition was nothing more than "a vehicle to steal Google's proprietary information."

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As part of the due diligence for the acquisition, Uber and its outside counsel, with the knowledge of the Uber board, had engaged Stroz Friedberg LLC, a computer forensic investigation firm, to investigate whether the ex-Google employees had taken Google's proprietary information with them to Otto. Stroz's preliminary report stated that the firm found that the employees possessed "substantial files" of Google proprietary information and had "surreptitiously tried to delete more" just before their interviews with Stroz. The report was delivered to Uber's General Counsel and outside legal counsel. The outside counsel expressed to Kalanick (but not otherwise to the board) "serious reservations" about the Otto acquisition in light of the litigation risk associated with the intellectual property issues. On April 11, 2016, the board met and approved the acquisition. At the meeting, the directors discussed generally the due diligence for the transaction, but the Stroz report was not presented to them and they did not inquire about it.

In February 2017, Google sued Otto and Uber for misappropriation of proprietary information. Ultimately, Uber settled the lawsuit by issuing $245 million of Uber stock to Google. Uber also terminated AL's employment. In June 2017, Uber terminated Kalanick as CEO–and at the end of 2019, Kalanick resigned from the board and, over the course of six weeks, sold his more than $2.5 billion of Uber stock. In December 2018, the plaintiff (an Uber stockholder) filed this derivative suit against Kalanick and the Uber directors who had approved the Otto acquisition. Uber moved to dismiss the suit against the directors based on the plaintiff's failure to make a pre-suit demand on the board to pursue the claims. The Court of Chancery, in an opinion issued by Vice Chancellor Glasscock, found that a majority of the board had been independent and disinterested and that demand therefore was not excused. The Supreme Court, in an opinion written by Justice Seitz, upheld the Court of Chancery's decision and dismissed the case.

Discussion

Delaware's long-standing principles relating to demand futility and director independence. Before a stockholder pursues derivative litigation, the stockholder must make a demand on the board to pursue the claims. Under the *Rales* test (which applies when a majority of directors in office at the time of the challenged conduct have been replaced on the board), demand will be excused if there is a reasonable doubt as to whether a majority of the directors at the time the complaint was filed could have considered the demand impartially. Directors are presumed to be independent and disinterested and thus capable of considering a demand impartially. However, the presumption can be rebutted with respect to any director if the facts pled indicate that the director was himself or herself self-interested with respect to the litigation or was not independent of (*i.e.*, was "under the dominion of" or "beholden to") another director who was self-interested.

One of the circumstances under which a director will be viewed as self-interested is if he or she faces "a substantial likelihood of personal liability" for the conduct alleged in the complaint. A director will be viewed as not independent of another director if the alleged facts indicate (i) that he or she has a material "personal or financial relationship" with the other director or (ii) (where the other director is a controller) that "the directorship is of significant material importance" to the director. The Supreme Court reiterated in *Kalanick* that "[t]he demand futility test is highly dependent on the particularity of the facts alleged" in a complaint.

The Supreme Court affirmed the Court of Chancery's finding that a majority of the Uber directors were independent for demand futility purposes. The plaintiff argued that a majority of the directors (i) were self-interested because they faced a substantial likelihood of personal liability for the conduct alleged in the complaint; and (ii) were not independent of Kalanick, whose conduct was being challenged. As we discuss below, the Supreme Court agreed with the Court of Chancery's findings that the directors (i) did *not* face a substantial likelihood of personal liability and (ii) were independent of Kalanick.

The Supreme Court found that the directors did not face "a substantial likelihood of personal liability"–because they were exculpated from duty of care violations and the alleged facts were insufficient to support an inference of "bad faith" for a duty of loyalty violation. The plaintiff contended that the Uber directors faced likely potential liability for breaches of their fiduciary duties in their consideration of the Otto acquisition. Specifically, the plaintiff alleged that, given the sensitivity of the intellectual property issues relating to the acquisition, the board at least should have read or inquired about the Stroz report and should not have simply relied on Kalanick's representations that there were appropriate protections against the theft of intellectual property (especially in light of Kalanick's history of misusing the intellectual property of others). However, the Court noted that, because Uber's charter exculpated the directors for breaches of the duty of care, they faced potential liability only for alleged breaches of the duty of loyalty.

To support a duty of loyalty claim, a plaintiff must allege particularized facts that support an inference that the director lacked independence, was self-interested, or acted in bad faith. The plaintiff did not allege that the directors (other than Kalanick) were themselves non-independent or self-interested with respect to the Otto acquisition, but argued that they had acted in bad faith. The Court reaffirmed that "bad faith" involves acting with "scienter"–which "mean[s] [the directors] had actual or constructive knowledge that their conduct was legally improper," there was "an intentional dereliction of duty," or the directors were "motivated by an actual intention to do harm." In the Court's view, while the Uber board clearly had approved a "flawed transaction," and the board likely "should have done more," the board did not appear to have acted in bad faith. The Court observed that the board "heard a presentation that summarized the transaction, reviewed the risk of litigation with Google, generally discussed due diligence, asked questions, and participated in a discussion." These facts raised an inference of a "functioning board" that was doing more than "rubber-stamping" a transaction proposed by Kalanick–and did *not* reasonably suggest that the board had *intentionally* ignored relevant risks.

The Supreme Court distinguished *Walt Disney* (where the Court of Chancery refused to dismiss the case at the pleading stage after finding that the plaintiff *had* sufficiently pled that the Disney directors may have acted in bad faith through an intentional dereliction of duties). In *In re Disney Deriv. Litig.* (2003), the plaintiff alleged that the Disney board approved a high-profile hiring decision before key details were negotiated and then assigned the responsibility to negotiate the contract to the CEO (who was a long-time good friend of the new hire). The *Disney* court noted that the board minutes reflected that there was little discussion by the board, no presentations were made to the board, the directors asked no questions, no expert consultant advised the board, and no review or approval by the board of the final terms of the agreement occurred. (We note that, after trial, the Court of Chancery found, and the Delaware Supreme Court affirmed, that the Disney directors had *not* acted in bad faith–which underscores how high the bar is to a bad faith finding in Delaware.)

The Supreme Court found that the plaintiff did not establish that a majority of the directors lacked independence from Kalanick. First, the plaintiff contended that the directors were not independent of Kalanick because he could appoint and remove them. (It is not clear from the complaint from where Kalanick derived the authority to appoint and remove directors.) The Court disagreed and reaffirmed the well-established principle that a director's being nominated or elected "by a director who controls the outcome" is insufficient to suggest a lack of independence. Second, the plaintiff argued that a majority of the directors were "beholden" to Kalanick. Given that the plaintiff did not challenge the independence of five of the eleven directors, if any one of the remaining six directors were independent, those considered independent would constitute a majority of the board. The court analyzed plaintiff's argument with respect to one of these remaining six, "JT." The plaintiff argued that JT was not independent because he had

been appointed by Kalanick "during a power struggle within Uber" after Kalanick was removed as CEO. In the plaintiff's view, the "context" of the appointment suggested that JT would be "loyal" to Kalanick. The Court found that "[JT] was independent because the plaintiff does not allege that [he] had a personal or financial connection to Kalanick or that the directorship was of substantial material importance to him." The Court stated: "[The] context of [JT]'s appointment–that Kalanick appointed him a power struggle and that [JT] might be loyal to him–without more does not allow a reasonable inference that [JT] and Kalanick's relationship was of a 'bias-producing nature.' Otherwise, a director would be automatically disqualified if appointed during a board conflict."

Does the decision signal a change in the Delaware courts' approach to determining director independence in the demand futility context? As noted, in the past few years, the Supreme Court, when considering demand futility, several times has overturned Court of Chancery findings that directors were independent. In these decisions (and Court of Chancery decisions that followed), the courts reiterated the long-established principles relating to demand futility and the presumption of director independence. However, in applying those principles to determine whether there was a material "personal or financial relationship" between a director and another person, the courts emphasized that the plaintiffs' allegations should be considered "holistically," based on "the constellation of facts," taken "in totality," and with "all reasonable inferences afforded to the plaintiff." To some commentators, the Supreme Court's finding in *Kalanick* that JT was independent suggests a return to a more strenuous presumption of director independence. This is certainly possible given that the Court did not accept what was arguably a "holistic" approach by the plaintiff in drawing an inference of non-independence from the totality of the circumstances (namely, that Kalanick, who was in a position to know, likely thought that JT would be loyal to him, which could indicate that he probably would be). Moreover, the Court did not make any reference to the theme of a "holistic" view of the "constellation of facts."

However, we would observe that the Court's brief analysis on the issue of JT's independence was grounded in the fact that the plaintiff did not allege *any* personal or financial relationship between JT and Kalanick but simply contended, as the Supreme Court articulated it, that the fact that JT was appointed by Kalanick during a power struggle at the company suggested that JT "might be loyal to him." In our view, this case thus differed from the others because, in the others, the plaintiff *did* allege personal and financial relationships and the issue was whether those relationships were sufficiently material to suggest non-independence.

We note that in one recent case (*BGC Partners* (2019)), the Court of Chancery determined that certain directors were not independent of the controller because, in addition to "overlapping social connections" (that the court viewed as likely not just "coincidences") they were the "go-to persons" for board positions on the controller's affiliated companies. In *Kalanick*, however, there was no allegation that JT was Kalanick's "go-to" person for board membership, only that he was appointed to Uber. Given that there was no allegation in *Kalanick* of any relationship other than the one board appointment, and in light of the Court's reaction to the plaintiff's appointed-during-a-power-struggle argument, in our view the case does not represent any real test of (and therefore should not be viewed as indicating a change in) the Delaware courts' approach on independence.

Practice Points

- ***A board should follow–and document–an appropriate process when considering a transaction.*** At a minimum, a board should have discussion among the members; review information about the financial, legal and other risks associated with the transaction; seek presentations from management, financial advisors, legal counsel, and/or expert consultants; ask questions; and follow

up on significant issues that are identified. While directors' failing to ensure an appropriate process will not result in liability except in egregious cases evidencing bad faith, their failing to exercise due care (*i.e.*, engaging in a process that the court deems to reflect recklessness) risks the transaction being enjoined pre-closing and also can affect directors' reputations.

- ***Management should seek to ensure that the board obtains the information it should have to consider a transaction.*** For example, as illustrated in *Kalanick,* if management or legal counsel arrange for reports by outside experts, the results of the reports generally should be presented to the board. If the board knows that consultants have been engaged and their reports have not been presented to the board, the directors should inquire about the reports.

- ***A board should be aware of and monitor potential independence issues.*** A board should consider having at least some clearly independent members. Together with legal counsel, a board should keep a head-count of directors who potentially could be deemed non-independent with respect to an action the board proposes to take. We note that there may be an even more strenuous judicial evaluation of independence when the context involves a quasi-judicial role by directors (such as when considering demand futility or with respect to a special litigation committee).

- ***A board should be alerted to–and consider the reasons for and impact of–"atypical" provisions in a merger agreement.*** The Uber-Otto merger agreement provided that (i) Uber would indemnify certain Otto employees for pre-signing misconduct disclosed during the Stroz investigation and (ii) Uber could not seek indemnification from AL for violations of his non-compete and non-infringement obligations to Google. The plaintiff argued that the combination of (a) the board's not having reviewed or inquired about the Stroz report and (b) these atypical indemnification provisions led to a reasonable inference that the board was on notice that Kalanick "wanted to steal Google's proprietary information"–and thus that the board acted in bad faith. Although the Court did not find bad faith, it clearly would have advantaged the board to have carefully considered the reasons for and potential impact of these unusual indemnity provisions.

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