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PERSPECTIVE

Demand futility in the 9th Circuit

By Bryan Ketroser

"*Overruled on other grounds by Brehm v. Eisner.*" If you have ever litigated corporate fiduciary duty claims, the odds are good that you — or your paralegal — have seen the above phrase countless times. Ever wonder why?

Motions to dismiss based on the sufficiency of allegations in a complaint usually are reviewed by courts of appeal *de novo*. However, once upon a time (i.e., the 20th century), the Delaware Supreme Court reviewed trial court decisions concerning the sufficiency of shareholder derivative plaintiffs' standing allegations under the deferential abuse of discretion standard. For instance, in the seminal 1984 case *Aronson v. Lewis*, Delaware's high court stated: "Our view is that in determining demand futility the Court of Chancery in the proper exercise of its discretion must decide whether, under the particular facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent [or] (2) the challenged transaction was otherwise the product of a valid exercise of business judgment." 473 A.2d 805, 814 (Del. 1984). For the next 16 years, the Delaware Supreme Court consistently and explicitly reaffirmed the applicability of the abuse of discretion standard to "demand futility" decisions in a string of cases that remain authoritative on a variety of Delaware corporate law issues. *See, e.g., Growbow v. Perot*, 539 A.2d 180, 186 (Del. 1988); *Levine v. Smith*, 591 A.2d 194, 207 (Del. 1991); *Grimes v. Donald*, 673 A.2d 1207, 1217 n.15 (Del. 1996).

Finally, in 2000, the Delaware Supreme Court realized that it had been applying the abuse of discretion standard to a scenario that did not warrant it. Thrice describing its prior statements on the subject (somewhat incredibly) as "dicta," the court acknowledged in *Brehm v. Eisner* that "our review of decisions of the Court of Chancery applying Rule 23.1 [derivative standing requirements] is *de novo* and plenary." 746 A.2d 244, 253 (Del. 2000). After all, in such cases, the lower court is not being asked to evaluate witness credibility, weigh expert evidence, etc. Rather, "the Court of Chancery, like this Court, is merely reading the English language of a pleading and applying to that pleading statutes, case law and Rule 23.1 requirements." *Id.* at 253-54. And, just like that, the Delaware Supreme Court ensured that many of its most-cited decisions would forever bear the brand: *"overruled on other grounds by Brehm v. Eisner."*

For those of us who practice securities litigation in the 9th Circuit, however, the story does not end there. Securities class action veterans likely are familiar with *In re Silicon Graphics Inc.*, the 1999 case in which the 9th Circuit explicated the "scienter" pleading requirements for plaintiffs alleging claims under Section 10(b) of the Securities Exchange Act of 1934. 183 F.3d 970 (9th Cir. 1999). What many may not know is that *In re SGI* also involved a related derivative suit. In passing on that suit, the court held — as the Delaware Supreme Court had up to that point — that "[w]e review for abuse of discretion the district court's finding that it would not have been futile for Janas to make a demand on SGI's directors[.]" *Id.* at 983. As support, the court cited *Greenspun v. Del E. Webb Corp.*, 634 F.2d 1204 (9th Cir. 1980), a case which in turn cited a 1963 9th Circuit case: *DePinto v. Provident Sec. Life Ins. Co.*, 323 F.2d 826 (9th Cir. 1963). The latter case, in an apparent example of unusual facts making bad law, noted that "the normal procedure is to look solely to the allegations of the complaint" in determining whether demand futility has been pleaded, but that the trial court had, in acting upon a party's motion to intervene as plaintiff, "received evidence in the form of testimony and exhibits which it considered in determining whether a demand ... would have been futile." *Id.* at 830 & n.7 (also citing Moore's Federal Practice for the proposition that "it lies within the sound discretion of the court to determine the necessity for a demand").

Just three years later, Rule 23.1 of the Federal Rules of Civil Procedure went into effect, codifying the demand futility rule as a pleading requirement. For the 9th Circuit, however, the die had been cast; the court repeated the abuse of discretion standard in *Greenspun* (1980) and *In re SGI* (1999), as well as eight years after *Brehm* in *Potter v. Hughes*, 546 F.3d 1051, 1056 (9th Cir. 2008).

More recent decisions suggest that change may yet be coming — eventually. In *Rosenbloom v. Pyott*, plaintiffs urged the 9th Circuit to review the dismissal of their derivative claims under a *de novo* standard, relying in part on *Brehm*. 765 F.3d 1137 (2014). While the majority opinion declined the invitation, the late Judge Stephen Reinhardt, in a concurring opinion, "wr[o]te separately to set forth [his] view that the proper standard is *de novo*" and to "strongly urge that when we are presented with a demand futility case in which the standard of review is determinative of the outcome, reconsideration of the applicable standard of review would be in order." *Id.* at 1159-60.

In the meantime, the 9th Circuit continues to review dismissals of shareholder derivative actions on demand futility grounds for abuse of discretion. Just this past summer, in *Tindall v. First Solar Inc.*, derivative plaintiffs again tried to convince the court to review their demand futility allegations *de novo*. 892 F.3d 1043 (9th Cir. 2018). While acknowledging that the argument "has persuaded other courts," the panel declined to consider its merits "because binding authority compels us, as a three-judge panel, to apply abuse of discretion review." *Id.* at *1.

In the author's opinion, the issue is overripe for the reconsideration that Judge Reinhardt recommended. Even if it means that 9th Circuit practitioners may get an *"overruled on other grounds"* clause of their very own.

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