Ninth Circuit reaffirms that a plaintiff must plead detailed facts demonstrating that at least half of directors could not have exercised disinterested business judgment in responding to a shareholder demand

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On December 26, 2018, the Ninth Circuit issued a decision in *Towers v. Iger*, No. 17-15770, affirming the dismissal of a shareholder derivative suit due to the plaintiff's failure to satisfy the demand futility requirement. The decision demonstrates that to show demand futility, a plaintiff needs to allege particularized facts establishing that a majority of directors *knew* of the improper activity alleged in the complaint.

The complaint alleged that Disney engaged in a long-running conspiracy with other animation studios and special effects firms "to suppress the compensation of skilled technicians." Op. at 4. Allegedly, the conspiracy began in the 1980s when Lucasfilm and Pixar agreed to refrain from recruiting each other's employees, and in subsequent years grew to include "gentlemen's agreements" with other companies that "prohibit[ed] cold calling" of employees. *Id.* at 4-5. The complaint further alleged that the conspiracy was orchestrated by the president of Pixar (Edwin Catmull) and that when Disney purchased Pixar in 2006, it "agreed to abide by the conspiracy" and its then-chairman, Richard Cook, "explicitly endors[ed] the scheme in an email exchange with Catmull." *Id.* at 5-6. In 2010, Pixar and other companies entered into settlements with the Department of Justice following an investigation into their hiring practices and were enjoined from entering into agreements to refrain from competing for employees. *Id.* at 6. Subsequently, class action lawsuits were filed against those companies. *Id.* at 7. The plaintiff alleged that documents disclosed in the DOJ investigation and those lawsuits revealed evidence of a conspiracy involving Disney itself, which unlike its subsidiaries (including Pixar), had not been implicated previously. *Id.* The plaintiff did not make a demand on the board, and the district court dismissed the complaint because the plaintiff had not shown that such a demand would have been futile. *Id.* at 8, 10.

The Ninth Circuit affirmed the district court's dismissal of the complaint on the basis that the plaintiff had failed to show demand futility under Federal Rule of Civil Procedure 23.1. *Id.* at 9. Rule 23.1 requires a complaint to "state with particularity . . . any effort by the plaintiff to obtain the desired action from the directors or comparable authority" as well as "the reasons for not obtaining the action or not making the effort." While this is a federal pleading requirement, the Ninth Circuit looks to the substantive law of the state of incorporation—here, Delaware—to determine whether a demand is in fact futile. *Id.* at 10 & n.4. The court explained that while a "smoking gun" of board knowledge is not required, and that a plaintiff may instead allege "particular facts that support an *inference* of conscious inaction," Delaware law requires that a plaintiff must "plead facts *specific to each director*, demonstrating that at least half of them could not have exercised disinterested business judgment in responding to a demand." *Id.* at 11 (citations omitted).

The court held that each of the three "general allegations" that the plaintiff relied upon to support such an inference was inadequate. First, although the complaint alleged that "certain high-ranking Disney officers"—including Catmull and Cook—"knew of the conspiracy and discussed its implications," the fact that such "*non-Board* corporate officers might have discussed or even guided the conspiracy" was not

sufficient to implicate the *directors* under Delaware precedent. *Id.* at 13-14. Instead, the court held that the plaintiff would have needed to "demonstrate a clear line of communication and knowledge between the implicated officers and the Board." *Id.* at 14.

Second, the complaint alleged that seven of the eleven directors had served on the board during the time period when the alleged conspiracy was in effect and that it was reasonable to infer that Cook was "sharing" information about the conspiracy with those board members, in light of language from a 10-K regarding the "significant adverse effects that employment costs can have on the Company." *Id.* at 15. The court held that because the 10-K did not discuss "employment costs" in the "context of competitors' pilfering of Disney employees or the Board's efforts to prevent it," the plaintiff could not tie the 10-K to the conspiracy sufficiently to support the inference that the board had knowledge of the conspiracy. *Id.*

Finally, the plaintiff relied upon board minutes from around the time of Disney's acquisition of Pixar in which the board discussed issues related to the merger. *Id.* at 16. The court held that the allegations regarding those minutes were inadequate to support an inference that the board knew of the conspiracy, explaining that "knowledge of misconduct cannot be imputed to the [directors] simply because the Board oversaw an acquisition that touched on related issues." *Id.* at 16-17.

In holding that none of the allegations in the complaint constituted "particularized facts demonstrating demand futility," the court distinguished a prior Ninth Circuit decision, *Rosenbloom v. Pyott*, 765 F.3d 1137 (9th Cir. 2014). The court explained that in *Rosenbloom*, the plaintiffs had offered a "battery of particularized factual allegations" that "strongly" supported an inference that the board knew of, and did nothing about, illegal activity. *Id.* at 18 (citing *Rosenbloom*, 765 F.3d at 1152). The court explained that *Rosenbloom* involved allegations that the board "closely and regularly monitored" potentially illicit activities, "received data" that qualified as a "red flag" of such activities, and "received repeated FDA warnings" about illegal activities. By contrast, the court found that it was not clear from the complaint whether the Disney board was even "*aware* of a conspiracy." *Id.* The court concluded that the allegations showed nothing more than that the board was "in close proximity to officers who were involved with the conspiracy, and that its members discussed related issues at meetings." *Id.* at 18-19. The court noted that these allegations were especially inadequate in light of the deferential abuse of discretion standard used to review dismissal for failure to plead demand futility, but suggested that they would "likely be insufficient even under de novo review." *Id.* at 19.

The panel included Chief Judge Sidney R. Thomas, Circuit Judge Milan D. Smith, Jr., and District Judge Elaine E. Bucklo, sitting by designation.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Charles S. Duggan	**212 450 4785**	**charles.duggan@davispolk.com**
Neal A. Potischman	**650 752 2021**	**neal.potischman@davispolk.com**
Amelia T.R. Starr	**212 450 4516**	**amelia.starr@davispolk.com**
Arif H. Dhilla	**650 752 2033**	**arif.dhilla@davispolk.com**
Andrew Yaphe	**650 752 2088**	**andrew.yaphe@davispolk.com**