

ARKANSAS COURT OF APPEALS HOLDS THAT SHAREHOLDER-
DERIVATIVE ACTIONS IMPLICATING THE FUTILITY EXCEPTION
TO THE PRE-SUIT DEMAND REQUIREMENT MUST
DEMONSTRATE THE DEMAND WOULD BE FUTILE BY MEETING
THE TWO PRONG ARONSON TEST

In *Berry v. Dillard*,¹ the Court of Appeals applied Delaware law, invoking the futility exception to the requirement of presuit demand in a shareholder-derivative action, holding that derivative-actions must comply with “stringent requirements of factual particularity”² and that “if an appeal is taken, the option to plead further is waived in the event of an affirmative.”³

Billy Berry (“Berry”) filed a shareholder-derivative action⁴ against various officers and directors (“the Board”) of Dillard’s, Inc., (“Dillard’s”) alleging the Board breached their fiduciary duties of loyalty and good faith to the shareholders by approving an exorbitant compensation package for the Dillard family despite the company’s financial condition.⁵ Specifically, Stephens, Johnson, and Connor, members of the Board’s compensation committee, were alleged to have breached their fiduciary duties to the company and its shareholders by approving the compensation package.⁶ Freeman, Haslam, Martin, Mori, and White were alleged to have breached their fiduciary duties to the company and its shareholders by “knowingly allow-

1. 2011 Ark. App. 242, ___ S.W.3d at ___.

2. *Id.* at 8, ___ S.W.3d at ___ (quoting *Brehm v. Eisner*, 746 A.2d. 244, 254 (Del. 2000)).

3. *Id.* at 12, ___ S.W.3d at ___ (citing *Sluder v. Steak & Ale of Little Rock, Inc.*, 368 Ark. 293, 298-99, 245 S.W.3d 115, 118 (2006)). Arkansas courts have dealt with the presuit demand requirement in only one other case. *See Morgan v. Robertson*, 271 Ark. 461, 467–68, 609 S.W.2d 662, 665 (Ark. App. 1980) (stating where a majority of the directors are under the control of a majority of the stockholders, and an action is brought against them by an innocent shareholder in his own name, charging wrongdoing on their part in the manner above indicated, it is not necessary for him to allege and prove, as a condition precedent to the maintenance of the action, that, before instituting the same, he protested to the board of directors against their own mismanagement and appealed to them for redress. Such protest would fall upon deaf ears, because a majority of the directors could not be expected to authorize, or to institute, an action against themselves charging themselves with fraud).

4. *Berry*, 2011 Ark. App. 242, at 6, ___ S.W.3d at ___ (explaining that “[a] derivative action is a procedural device that permits shareholders to assert a claim belonging to the corporation and on the corporation’s behalf”) (internal citation omitted).

5. *Id.* at 1–2, ___ S.W.3d at ___ (naming William Dillard II, James I. Freeman, Alex Dillard, Mike Dillard, Drue Matheny, James A. Haslam III, Peter R. Johnson, Robert C. Connor, R. Brad Martin, Frank R. Mori, Warren A. Stephens, and Nick White).

6. *Id.* at 2, ___ S.W.3d at ___.

ing the exorbitant compensation to continue and by failing to provide oversight as required by their positions.”⁷ Additionally, Berry alleged that four members of the Dillard family and Stephens were unjustly enriched by the compensation package to the detriment of the shareholders.⁸

Berry alleged that the Dillard members of the Board rewarded Stephens’ approval of their compensation by making “excessive and improper payments” to Stephens corporation under the guise of evaluating Dillard’s partial ownership options of CDI, Inc.⁹ Berry presented Dillard’s decision to employ Stephens, Inc., without input or approval from the Board, as evidence that the Board members violated their fiduciary duties and as additional support for his claim of unjust enrichment against Warren Stephens.¹⁰

Because several of the directors of the board were either Dillard family members or key executives that also owned entities doing business with Dillards, Inc., Berry pled presuit demand futility, alleging it was impossible for the Board to “independently or disinterestedly” consider the allegations.¹¹ In his complaint, Berry identified specific reasons for each defendant that demonstrated why a presuit demand would be futile, including “familial ties, business ties, professional ties, direct oversight of the corporate misconduct, direct participation in the corporate misconduct, failure to remedy the corporate misconduct, authorization or acquiescence in the corporate misconduct, employment with Dillard’s, the likelihood of liability, the possible lack of insurance coverage, the possible resulting civil actions, and the domination and control of the Dillard family over the other board members.”¹²

The Board responded to Berry’s complaint by filing a motion to dismiss on two grounds: 1) failure to plead “particularized facts demonstrating that demand would have been futile,” and 2) failure to “state a claim against the directors because the Restated Certificate of Incorporation eliminates the personal liability of directors to the company for the claims asserted in the complaint.”¹³

In his response, Berry maintained that it was dubious whether the Dillard family Board members, Warren Stephens or James Freeman, could be independent or disinterested (given their personal stake in the outcome), thus demand was futile.¹⁴ Although Berry also asserted the demand requirement was also excused regarding his allegations of corporate waste and

7. *Id.* at 2, ___ S.W.3d at ___.

8. *Id.*, ___ S.W.3d at ___.

9. *Id.* at 2–3, ___ S.W.3d at ___.

10. *Berry*, 2011 Ark. App. 242, at 3, ___ S.W.3d at ___.

11. *Id.*, ___ S.W.3d at ___.

12. *Id.*, ___ S.W.3d at ___.

13. *Id.* at 3–4, ___ S.W.3d at ___.

14. *Id.* at 4, ___ S.W.3d at ___.

unjust enrichment, he did not pursue these issues on appeal.¹⁵ Lastly, Berry argued that his complaint stated proper claims under ARK. R. CIV. P. 12(b)(6).¹⁶

At the hearing, the trial court granted the Board's motion to dismiss and found that Berry's complaint failed to allege sufficient facts, thus creating a reasonable doubt that the Board members that were not Dillard family members could exercise disinterested and independent judgment considering a presuit demand.¹⁷ Berry appealed following the trial court's ruling.¹⁸

Because Dillard's, Inc. is incorporated in Delaware, the Court of Appeals applied Delaware law.¹⁹ In Delaware, the business-judgment rule "mandates deference to directors' decisions, presuming that, in making a business decision, the directors of a corporation acted on an informed basis, in good faith, and with the honest belief that the action taken was in the best interests of the company."²⁰ Further, it is settled Delaware law that in a derivative suit, "shareholders must demonstrate either that a demand was made on the board and it was wrongfully refused or that demand should be excused because the directors are incapable of making an impartial decision regarding such litigation."²¹

The Court of Appeals noted the three purposes of the demand requirement: 1) it "requires the exhaustion of intracorporate remedies and provides an alternative-dispute-resolution process that may prevent the litigation," 2) if the derivative suit has merit, the "presuit demand on the board allows the directors to control the proceedings," and 3) if "the board wrongfully refuses to initiate the action, the shareholder can then control the proceedings."²²

The Court then applied a disjunctive two prong test, set forth by the Delaware Supreme Court in *Aronson*, to evaluate "conscious board decisions."²³ The first prong is "whether, under the particularized facts alleged, a reasonable doubt is created that ... the directors are disinterested and independent."²⁴ The second prong is "whether the pleading creates a reasonable doubt that the challenged transaction was otherwise the product of a valid exercise of business judgment."²⁵ The Board's failure to act or "unconscious decisions" is evaluated using the *Rales* test — "whether or not the particu-

15. *Id.*, ___ S.W.3d at ___.

16. *Berry*, 2011 Ark. App. 242, at 4, ___ S.W.3d at ___.

17. *Id.*, ___ S.W.3d at ___.

18. *Id.*, ___ S.W.3d at ___.

19. *Id.* at 5, ___ S.W.3d at ___.

20. *Id.* at 6, ___ S.W.3d at ___ (citing *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000)).

21. *Id.*, ___ S.W.3d at ___ (citing *Rales v. Blasband*, 634 A.2d 927, 932 (Del. 1993)).

22. *Berry*, 2011 Ark. App. 242, at 6–7, ___ S.W.3d at ___.

23. *Id.* at 7, ___ S.W.3d at ___.

24. *Id.*, ___ S.W.3d at ___ (citing *Aronson*, 473 A.2d at 814).

25. *Id.*, ___ S.W.3d at ___.

larized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand.”²⁶ However, the Delaware Supreme Court held that “derivative-action pleadings ‘must comply with *stringent requirements of factual particularity* that differ substantially from the permissive notice pleadings,” and that “conclusory statements or mere notice pleading” is insufficient.”²⁷

The Court noted the circumstances in which the Delaware Supreme Court outlined when demand would be excused: 1) a “majority of the board has a material financial or familial interest,” 2) a “majority of the board is incapable of acting independently for some other reason such as domination or control,” or 3) the “underlying transaction is not the product of a valid exercise of business judgment.”²⁸ In order for the demand to be excused as futile, “Berry must show that a majority of the board is both interested in the challenged transactions and lacking independence” for his complaint to survive a motion to dismiss. However, Berry’s complaint improperly conflated these elements.²⁹

The Court then focused on Berry’s allegations against James Freeman and Warren Stephens, noting that his complaint contained no allegations that Freeman was interested in the compensation or transactions between the Dillard family or between Stephens, Inc. and Dillard’s.³⁰ Instead, the complaint argued that Freeman could not be independent due to his position as chief financial officer.³¹ While the Court agreed that Berry raised reasonable doubt as to Freeman’s independence due to his principle appointment, Berry failed to show that the majority of the Board was interested and lacking independence.³²

Next the court examined Stephens’ relationship to Dillard’s and Stephens, Inc., finding that he was interested because he “stood on both sides of the transactions.”³³ The court relied on the Delaware Supreme Court’s holding in *Cede & Co. v. Technicolor, Inc.* that “self interest alone” is not sufficient to disqualify a director absent “evidence of disloyalty such as the mo-

26. *Id.* at 8, ___ S.W.3d at ___ (quoting *Rales*, 634 A.2d at 932).

27. *Id.*, ___ S.W.3d at ___ (quoting *Brehm*, 746 A.2d at 255).

28. *Berry*, 2011 Ark. App. 242, at 9, ___ S.W.3d at ___ (quoting *Grimes v. Donald*, 673 A.2d 1207, 1216–17 (Del. 1996)).

29. *Id.*, ___ S.W.3d at ___.

30. *Id.*, ___ S.W.3d at ___.

31. *Id.*, ___ S.W.3d at ___.

32. *Id.* at 10, ___ S.W.3d at ___.

33. *Id.*, ___ S.W.3d at ___.

tives of entrenchment, fraud upon the corporation or the board, abdication of directorial duty, or the sale of one's vote."³⁴

Because Berry's complaint did not allege that Stephens lacked independence and failed to provide "particularized factual allegations from which the Court . . . can infer that the board members who approved the transaction are acting at the direction of the allegedly dominating individual or entity," the Court found his complaint deficient.³⁵ Although Berry's complaint alleged quid pro quo transactions between Dillard's and Stephens, Inc., these transactions were not linked factually to the compensation paid to members of the Dillard family, nor did the complaint allege that these transactions were "not in the best interest of Dillard's, Inc., or its shareholders."³⁶

Berry argued that he should be permitted to amend his complaint to properly allege demand futility, but under Arkansas procedural law, "the option to plead further is waived in the event of an affirmance."³⁷ The Court was not persuaded by this argument.³⁸

This case reinforces the importance of pleading shareholder derivative actions with *stringent factual particularity*. Secondly, this case upholds the use of the Aronson two prong test.³⁹

* Kitty Malcolm

34. *Berry*, 2011 Ark. App. 242, at 10, ___ S.W.3d at ___ (citing *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 362 (1993)).

35. *Id.* at 10–11, ___ S.W.3d at ___ (quoting *Heineman v. Datapoint Corp.*, 611 A.2d 950, 955 (Del. 1992) (stating that "[b]ecause Berry's allegations are conclusory, the complaint fails to properly plead a basis showing that the demand would be futile. As such, the circuit court properly dismissed Berry's complaint")).

36. *Id.* at 11, ___ S.W.3d at ___.

37. *Id.* at 12, ___ S.W.3d at ___.

38. *Id.*, ___ S.W.3d at ___ (citing *Sluder v. Steak & Ale of Little Rock, Inc.*, 368 Ark. 293, 298 245 S.W.3d 115, 118 (2006); *White v. Panic*, 783 A.2d 543 (Del. 2001) (explaining that "[t]he policy against permitting stockholder plaintiffs to amend their complaints after an unsuccessful appeal encourages the plaintiff to investigate their claims before filing a complaint so that they have a basis at the outset to make particularized factual allegations in the complaint.")).

39. *Berry*, 2011 Ark. App. 242, at 6, ___ S.W.3d at ___ (citing *Brehm*, 746 A.2d at 253 (Del. 2000)).