

Derivative Suit Dismissed for Failing to Plead Demand Futility

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In *Shabbouei v. Potdevin*, C.A. No. 2018-0847-JRS (Del. Ch. Apr. 2, 2020), the Delaware Court of Chancery dismissed a derivative suit against the board of directors (the “Board”) of lululemon athletica inc. (the “Company”) by a Company stockholder (“Plaintiff”) for failing to plead demand futility. The Court held that Plaintiff did not plead with the requisite particularity that the Board was self-interested in a Separation Agreement with the Company’s CEO Laurent Potdevin (“Potdevin”) negotiated by the Board and that the Board’s decision to settle with, instead of firing, Potdevin for cause was outside the bounds of proper business judgment.

After verifying reports that Potdevin had engaged in pervasive misconduct by creating a toxic culture at the Company and engaging in a pattern and practice of harassment and sexual favoritism, the Board pursued a negotiated separation of Potdevin from the Company rather than terminating Potdevin for cause. The Board made this decision after consulting extensively with outside counsel and after meeting as a Board several times over the course of three months. The Separation Agreement called for severance payments to Potdevin totaling \$5 million. Plaintiff brought a suit against the directors alleging, among other things, that the directors breached their fiduciary duties by approving the Separation Agreement and that the Separation Agreement constituted waste.

The directors moved to dismiss the complaint under Court of Chancery Rule 23.1 arguing that Plaintiff failed to make demand on the Board and failed to plead demand futility. Plaintiff acknowledged that Plaintiff did not make pre-suit demand. Since Plaintiff challenged an affirmative decision of the Board (i.e., the entering into of the Separation Agreement), the Court analyzed demand futility under the standard established in *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984), which required Plaintiff to plead particularized facts in support of a reasonable inference that either (i) a majority of the board was “interested” in the challenged decision, or (ii) the challenged decision was not a product of valid business judgment.

To adequately plead demand futility because the Board was “interested” in the Separation Agreement as a means to hide the Board’s slow response to Potdevin’s malfeasance as Plaintiff alleged, the Court held, Plaintiff was required to plead particularized facts supporting a reasonable inference that at least five of the Company’s 10 directors (i) appeared on both sides of the transaction, (ii) derived a personal financial benefit from the transaction, or (iii) were beholden to an interested person. Further, the Court ruled that Plaintiff was required to plead facts supporting an

inference that the Separation Agreement extinguished a substantial likelihood of Board liability.

The Court determined that Plaintiff did not satisfy this pleading requirement, since Plaintiff did not attempt to plead a failure of oversight claim and did not allege that the Board faced a substantial likelihood of liability for such a claim. The Court found it inconceivable that the Board “utterly failed” to establish a relevant information and reporting system given that the Company had an ethics code and a whistleblower hotline, which were used to detect Potdevin’s wrongdoing. The Court also held that the complaint did not support a reasonable inference that the Board consciously disregarded a duty to act, finding that the Board promptly hired outside counsel to investigate alleged misconduct by Potdevin, reviewed counsel’s report, authorized a Board member to negotiate Potdevin’s resignation, and secured Potdevin’s departure.

To adequately plead demand futility on the basis that the Separation Agreement was not a product of valid business judgment, the Court ruled, Plaintiff was required to well plead that a majority of the Board acted in breach of its duty of loyalty, since the Company’s certificate of incorporation contained a clause exculpating the directors from liability for duty of care violations. In other words, the challenged decision had to be so egregious on its face that Board approval could not have met the test of business judgment.

The Court also determined that Plaintiff did not satisfy this pleading requirement. Rejecting Plaintiff’s allegation that the Board allowed Potdevin to decide his own fate by authorizing a Board member to negotiate a “potential” separation with Potdevin, the Court ruled that this authorization does not support a reasonable inference that the Board deferred to Potdevin’s judgment. The Court also disagreed with Plaintiff’s argument that the Board had a duty to make a decision to fire Potdevin before the negotiation, determining that the more reasonable approach was the one taken by the Board. Regarding Plaintiff’s allegation that the Board was too slow in responding to Potdevin’s malfeasance and then rushed to enter into the Separation Agreement, the Court held that it was the Board’s prerogative to decide when it had enough information to proceed to separate Potdevin from the Company. Settling with Potdevin was within the bounds of proper business judgment, the Court decided, since firing Potdevin for cause could have involved the Company in an embarrassing lawsuit. The Court also determined that the Board’s decision to meet informally to discuss how to deal with Potdevin was entitled to deference and did not support an inference of wrongdoing by the Board.

The Court then addressed Plaintiff’s argument that the severance payments to Potdevin pursuant to the Separation Agreement constituted corporate waste. To state this claim, Plaintiff was required to plead facts that allowed a reasonable inference that the Separation Agreement amounted to a transfer of assets that served no corporate purpose or for which no consideration was received. Plaintiff failed to meet this standard as the Court found numerous corporate benefits arising from the Separation Agreement. Such benefits included (i) Potdevin releasing all claims he had against the Company, (ii) the removal of Potdevin as CEO of the Company, and (iii) the Company potentially avoiding costly and embarrassing litigation.

For these reasons, the Court dismissed the complaint with prejudice.

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