

[Securities Regulation Daily Wrap Up, DIRECTORS AND OFFICERS—Del. Ch.: Derivative suit dismissed for failure to show demand was futile, \(Feb. 29, 2016\)](#)

Securities Regulation Daily Wrap Up

[Click to open document in a browser](#)

By [Kevin Kulling, J.D.](#)

A Delaware Chancery Court has dismissed a derivative suit that alleged the board of directors of Zynga, Inc. misused confidential internal information, breached a duty of loyalty and failed to disclose material changes to its financial condition. The court said that the stockholder who brought the suit failed to establish that making a pre-suit demand on the board would have been futile ([Sandys v. Pincus](#), February 29, 2016, Bouchard, A.).

Zynga secondary offering. Zynga, Inc., which develops and markets social games such as *Farm Ville* and *Words With Friends*, sold shares of Class A common stock in its initial public offering in December 2011. At that time, Zynga and its directors, officers, and various employees entered into lock up agreements with the underwriters of the IPO that prohibited them from selling shares of Zynga stock for up to 165 days following the IPO.

Zynga's board approved a secondary offering, allowing certain stockholders to sell shares before the expiration of the lock ups. On March 13, 2012, the Audit Committee approved exceptions to the trading window restrictions in Zynga's 10b5-1 trading plan to allow the secondary offering participants to sell shares in the secondary offering.

On March 29, 2012, Zynga filed a prospectus regarding the secondary offering, which included the company's historical operating financial metrics. On April 3, 2012, Zynga announced the secondary offering had been completed. The participants sold a total of 20 million shares for about \$236 million. Shortly thereafter, on April 26, 2012, Zynga announced that its earnings had declined for the first quarter of 2012, and Zynga's stock lost value as a result. By October 2012, Zynga's stock price had lost approximately 81 per cent of its value from the time of the secondary offering.

Allegations. The complaint alleged that the secondary offering participants had breached their fiduciary duties by misusing Zynga's confidential information when they sold shares while in possession of materially adverse, non-public information about the company. Secondly, the complaint alleged a breach of duty of loyalty for approving the secondary offering and against the audit committee members for exempting the secondary offering participants from trading restrictions to allow them to sell in the secondary offering. A third count alleged that all defendants breached their fiduciary duties by failing to put controls in place to ensure that Zynga made adequate public disclosures and avoided material omissions in its public statements.

Motion to dismiss. Zynga and the board defendants brought its motion to dismiss for a failure to make a pre-suit litigation demand. The court noted that applicable law required that a derivative plaintiff's complaint must allege with particularity the efforts made by the plaintiff to obtain the board's action and the reasons for the plaintiff's failure to obtain the action or for not making the effort. If no demand was made, the plaintiff must show that such a demand on the board would be futile.

The court further noted that in order to determine whether a demand upon the board would be futile, the plaintiff must plead facts that create a reasonable doubt either that the directors are disinterested and independent or that the challenged transaction was otherwise the product of a valid exercise of business judgment. In situations, such as here, where the majority of the members that made the challenged decision have been replaced, the court requires the plaintiff to create a reasonable doubt that the board could have properly exercised its independent and disinterested business judgment in responding to a demand at the time the complaint was filed.

Demand not excused. The court said that the Zynga stockholder was required to create a reasonable doubt that at least five of the nine directors on the board when the demand was to be made were disinterested and independent. The court determined that there were no allegations challenging the independence of any of the directors. The court noted that allegations of common membership on the board of another corporation was not sufficient to raise a reasonable doubt about independence. The court also was not persuaded by allegations that there were business or personal friendships among board members absent a relationship of a “bias-producing” nature.

The court also noted that Zynga's charter contained an exculpatory provision that defeated the potential argument that a director was interested because he was facing a risk of personal liability for approving the secondary offering.

Red flags. The stockholder alleged that directors ignored a “red flag” which was the request to waive trading restrictions during a period of declining business prospects. However, the court again found pleading deficiencies where the allegations did not contain particularized facts linking the allegations to the outside directors' knowledge or actions.

Because no reasonable doubt was raised as to the outside directors' impartiality, the board was not disabled from deciding whether to pursue any of the plaintiff's claims.

The case is [C.A. No. 9512-CB](#).

Attorneys: Norman M. Monhait (Rosenthal, Monhait & Goddess, P.A.) and Jeffrey S. Abraham (Abraham, Frutcher & Twersky, LLP) for Thomas Sandys. Elena C. Norman (Young Conaway Stargatt & Taylor, LLP) and Jordan Eth (Morrison & Foerster LLP) for Mark J. Pincus.

Companies: Zynga Inc.

LitigationEnforcement: CorporateGovernance DirectorsOfficers FiduciaryDuties
PublicCompanyReportingDisclosure DelawareNews