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DIRECTOR LIABILITY

Revisiting Director Independence and Disinterestedness in the Demand Futility Context

Recent opinions of the Delaware Chancery Court and Supreme Court in a case involving an acquisition by Uber Technologies, Inc. provide guidance on circumstances in which directors may need to "dig deeper" in particular areas. They also underscore the heightened pleading burden plaintiffs face when seeking to call into question the disinterestedness and independence of directors.

By John Mark Zeberkiewicz and Brian T.M. Mammarella

In *McElrath v. Kalanick*,[1] the Delaware Supreme Court affirmed the Chancery Court's opinion[2] dismissing derivative claims challenging a board's approval of what "[b]y any reasonable measure" was found to be "a flawed transaction."[3] In rejecting the plaintiff's arguments that questioned the disinterestedness and independence of a majority of the director defendants, the Court made clear that alleged non-economic conflicts of interest must be sufficiently disabling to call into question a director's ability to impartially consider the key issue of whether to initiate a lawsuit against an officer or fellow director. Although the claims against the directors were dismissed, the opinions of both the Chancery Court and Supreme Court nevertheless provide important guidance on circumstances in which directors may need to be on heightened alert—and may need to "dig deeper" into particular areas, including by seeking outside independent advice.

Background

The case arose out of Uber Technologies, Inc.'s (Uber) acquisition in 2016 of Ottomotto LLC (Otto).[4] According to the plaintiff, Travis Kalanick, Uber's then chief executive officer, eager to propel Uber into the self-driving car space, engineered a so-called "acqui-hire" of Otto, a company formed by Anthony Levandowski, a former Google employee who had been working on Google's self-driving car initiative.[5] According to the plaintiff, Kalanick continued to pursue the acquisition despite learning

John Mark Zeberkiewicz *is a director, and* **Brian T.M. Mammarella** *is an associate, of Richards, Layton & Finger, P.A. in Wilmington, DE. Although Richards, Layton & Finger may have been involved in some of the cases mentioned in this article, the views expressed herein are the views of the authors and are not necessarily the views of the firm or its clients.*

that Levandowski had taken intellectual property and trade secrets from Google.[6]

Before presenting the proposed acquisition to the board of directors, Uber's management team retained the forensic firm Stroz Friedberg (Stroz) to investigate whether intellectual property had been misappropriated.[7] Stroz conducted due diligence, reached preliminary conclusions regarding those intellectual property issues, and presented its preliminary findings to representatives of Uber and Otto. At an April 2016 meeting of the board at which the Otto acquisition was proposed for approval, Stroz's preliminary findings were not presented to the board, although Uber's directors were aware that Stroz had been retained to conduct diligence.[8] At that meeting, the board also discussed the merger agreement, including the provisions indemnifying Otto's employees for prior acts to the extent truthfully disclosed to Stroz, as well as the fact that Uber was not being indemnified for any liabilities it inherited from Otto. The plaintiff alleged that the board approved the transaction without requesting to review Stroz's materials or otherwise seeking additional information, independent of management, regarding the due diligence conducted.[9]

Following the acquisition, an employee of Google noticed that Otto appeared to be using Google technology, resulting in Google filing suit against Uber and Otto for patent infringement and Uber settling those claims for $245 million.[10] Without making a pre-suit litigation demand on the board or demanding to inspect Uber's books and records pursuant to Section 220 of the Delaware General Corporation Law,[11] the stockholder-plaintiff commenced a derivative action for breach of fiduciary duty against certain Uber directors and officers. In essence, the plaintiff's theory was that Kalanick's "bad character" and purported "history as a copyright infringer" should have served as a sufficient red flag to put the board on notice that the representations it received from management were unreliable. According to the plaintiff, the directors' alleged process-oriented failures—for example, their alleged failure to insist on reading Stroz's preliminary report before approving the merger and final report before closing—that would otherwise constitute lapses in due care amounted to a conscious disregard of their fiduciary duties.[12] Since the defendants' conduct amounted to "bad faith," according to the plaintiff, the director defendants would not be exculpated from monetary liability under Uber's charter.[13] The defendants moved to dismiss on the grounds that the plaintiff had failed to make a demand on the board to pursue the litigation and was unable to show that demand was futile.

The Court of Chancery's Opinion

The Chancery Court granted the defendants' motion to dismiss on grounds that the plaintiff both failed to make a pre-suit litigation demand and failed to satisfy its burden under Court of Chancery Rule 23.1 that such a demand would have been futile.[14] The plaintiff's pleading-stage burden of showing demand futility was made particularly challenging since a majority of the directors at the time the complaint was filed (Demand Board) joined the board *after* the transaction was approved.[15] The board that approved the Otto acquisition consisted of Garrett Camp, Travis Kalanick, Ryan Graves, William Gurley, and David Bonderman (Transaction Board). By the time the complaint was filed, the composition of the board had changed dramatically. After the approval of the Otto acquisition but prior to closing, Uber expanded its board by two seats and appointed, per Kalanick's designation, Arianna Huffington and Yasir Al-Rumayyan. Post-closing, Gurley and Bonderman resigned from the board and were replaced by Matt Cohler and David Trujillo, both designees of venture capital firms, and two new directors, Ursula Burns and John Thain, were both appointed per Kalanick's designation. Given the shift in board composition between the time of the transaction's approval and the time the complaint was filed—only three persons who served on the Transaction Board continued to serve on the eleven-person Demand Board—the Court applied the standard enunciated in *Rales v. Blasband*,[16] which involves an inquiry into "'whether the board that

would be addressing the demand can impartially consider its merits without being influenced by improper considerations.'"[17]

By the time the complaint was filed, the composition of the board had changed dramatically.

As the Court noted, the so-called *Rales* test requires the Court to assess whether the plaintiff has alleged particularized facts that would create a reasonable doubt that, at the time of the complaint's filing, the board could have properly exercised its independent and disinterested judgment in responding to a demand. A director is interested in circumstances where he or she would face a "substantial likelihood of personal liability" for the conduct alleged in the complaint, and is independent when his or her decision is based on the "merits . . . rather than extraneous considerations."[18] The plaintiff claimed that nine of the eleven directors on the Demand Board were disabled from impartially considering the demand. Of those nine, the plaintiff alleged that five were not disinterested and seven were not independent. As to the seven "non-independent" directors, the plaintiff claimed that five were not independent of Kalanick and two were not independent of their successors in office (who were appointed by their respective venture capital funds).

The Court's Assessment of Director Disinterest

The plaintiff claimed that five directors on the Demand Board were not disinterested because they failed to act in good faith and committed waste by voting to approve the Otto transaction or not preventing it from closing. The plaintiff further alleged Kalanick was interested because he faced a substantial likelihood of liability for hiring Levandowski despite knowing Levandowski had retained Google intellectual property. In addressing these allegations, the Chancery Court ultimately concluded that, with the exception of Kalanick, none of the members of the Demand Board faced a substantial likelihood of liability.

The Chancery Court first examined Kalanick's conduct, in both his capacity as an officer and a director of Uber. The Court took note of the plaintiff's allegations that Kalanick was personally involved in the process to poach Levandowski from Google, that Kalanick had been in meetings where Levandowski admitted to retaining Google's confidential information, that Kalanick had been advised that Uber's General Counsel had reservations regarding the Otto acquisition, and that Kalanick failed to adequately inform the board of the risks of the transaction. The Court stated that Kalanick's alleged withholding of information material to the board's decision would constitute a violation of his duty of loyalty as an officer of Uber.[19] Moreover, the Court found that the plaintiff sufficiently had pled that Kalanick knowingly engaged in a plot to misappropriate Google's intellectual property through the Otto acquisition and, accordingly, held the plaintiff had sustained its pleading-stage burden of alleging Kalanick faced a substantial likelihood of liability for breaching his duty of loyalty. The Court further noted that, as the exculpation provision in Uber's charter only applied to directors (as provided by law), Kalanick did not benefit from it for his conduct *qua* officer. The Court also noted that it would not protect him from liability from any misconduct amounting to a breach of the duty of loyalty or knowing violations of law in his capacity as a director.[20]

Kalanick's alleged withholding of information material to the board's decision would constitute a violation of his duty of loyalty.

The Court was less receptive, however, to the plaintiff's arguments with respect to the remaining members of the Demand Board who were allegedly interested. The Court framed plaintiff's position as an argument "that the directors (other than Kalanick) at

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the time the Otto acquisition was approved acted in bad faith because they had a 'duty to act' to inform themselves of Stroz' preliminary findings."[21] Put differently, the plaintiff attempted to transform what would traditionally constitute a claim for breach of the duty of care—the failure of the directors to adequately inform themselves of all material facts—into a bad faith claim by arguing that, in light of Kalanick's alleged history of violating the law and engaging in unethical conduct, the directors' failure to so inform themselves amounted to an intentional dereliction of duty.

The plaintiff argued by analogy to cases arising in the duty of oversight context under *In re Caremark International Inc. Derivative Litigation*,[22] where the Court found the directors' actions lacking in circumstances where the board was aware of pervasive safety issues.[23] The Court determined those cases were distinguishable on their facts, reasoning that although Uber allegedly had a "history of flouting local regulations and laws governing car-for-hire services," the plaintiff's claim had nothing to do with those specific regulations. Further, the Court declined to infer that the directors should have been on notice of misconduct surrounding intellectual property by virtue of Uber's alleged history of violations in the car-for-hire space[24] and specifically rejected the plaintiff's attempt to allege that Kalanick's "'bad character'" was sufficient to "convert a plain vanilla duty of care allegation into a persuasive pleading of bad faith on the part of the directors."[25] Finally, the Court noted that the plaintiff's claims regarding Kalanick's alleged misconduct related to dealings with *third parties*; the plaintiff had not pled that Kalanick had been less than candid or forthright with *the board*.[26]

The Court also rejected the plaintiff's attempt to rely on cases in the area of executive compensation where directors were found, at the pleading stage, to have engaged in bad faith by consciously disregarding their duties.[27] Those cases, the Court reasoned, implicate circumstances where a board is necessarily "alert to the dangers of deference solely to the judgment" of executives due to their obvious conflicts. In the case of the Otto acquisition, by contrast, plaintiff had failed to plead the presence of any such structural conflict affecting directors and officers.[28]

The Court also rejected the notion that the structural features of the Otto acquisition itself should have given rise to a special duty on the part of the directors to engage in further investigative efforts before approving the transaction. That the merger agreement contained unique indemnification provisions did not, according to the Court, give rise to a finding that the directors must have known that the transaction was "illicit."[29] As the Court stated, "a failure to follow best practices is not necessarily a breach of fiduciary duty."[30]

The Chancery Court's Assessment of the Directors' Independence

The Court then addressed the plaintiff's challenges to the independence of seven members of the Demand Board, asking the key question: '"independent from whom and independent for what purpose?'"[31] In the absence of classic disabling conflicts of interest, and having found that only Kalanick faced a substantial likelihood of liability, the Court concluded that the plaintiff had to demonstrate that a majority of the directors considering the demand were not independent of Kalanick. Here, the Court noted that, to demonstrate a lack of independence, the plaintiff had to show material ties—specifically, financial circumstances or personal affinities—to Kalanick that would affect directors' impartiality.[32]

'A failure to follow best practices is not necessarily a breach of fiduciary duty.'

The Court first took up the plaintiff's allegations that two directors—Matt Cohler and David Trujillo—were interested because their acquaintances who served on the Transaction Board faced a substantial likelihood of liability for approving the Otto transaction. In particular, the plaintiff alleged Cohler had been Gurley's mentee at the same

investment fund and Trujillo had been partners with Bonderman at a different investment fund. Because the Court had earlier concluded that no Transaction Board member other than Kalanick faced a substantial likelihood of liability, it dismissed these allegations as insufficient for purposes of *Rales*.[33]

The Court then assessed the plaintiff's claim that Ryan Graves was not independent of Kalanick on the basis that Kalanick had hired Graves as Uber's first employee and that the two were friends.[34] While noting that the Delaware courts have found "long and close" personal friendships may be sufficient to overcome the presumption of independence, facts relating to those relationships—and their effect on a director's impartiality—must be pled with particularity. In this case, the plaintiff's conclusory allegations that Graves was a "confidant" and an "ally" were insufficient to clear that hurdle.[35] Moreover, the fact that Graves derived substantial wealth from his position at Uber was not sufficient to render him not independent of Kalanick, who was no longer the CEO and had no means to deprive Graves of his accumulated wealth.[36]

Next, the plaintiff alleged that John Thain lacked independence on the basis that Kalanick had unilaterally appointed him to the board during a "power struggle" that was underway at Uber.[37] Even if Kalanick had the power to remove Thain, that fact alone was not sufficient to undermine Thain's independence. The plaintiff had not alleged that Thain had a personal or financial relationship with Kalanick or that the Uber directorship was of substantial importance to Thain.[38] The Court then addressed the plaintiff's claim that Ursula Burns was not independent due to her appointment by Kalanick and for the additional reason that Kalanick is a client of her employer.[39] The Court rejected the former on the same grounds it rejected the challenge to Thain's independence. As to the latter, while it was not required to address the issue,[40] the Court observed that the plaintiff's pleading was conclusory with respect to the materiality of the relationship. Next, the Court addressed, for purposes of completeness, the plaintiff's challenges to Arianna Huffington's independence—namely, that Kalanick unilaterally appointed her to the board and that she was a close personal friend of his.[41] Although not required to address the issue due to its prior findings, the Court observed that plaintiff's pleadings that Huffington "visited Kalanick's family members in the hospital and made him omelettes . . . approach, if not cross, a line of independence."[42]

The Supreme Court's Affirmance

Although the Supreme Court observed that Uber's board had "approved a flawed transaction," the high Court concurred with the Chancery Court's conclusion that a majority of the board was disinterested, facing no real threat of personal liability due to the exculpatory provision in Uber's charter, and that a majority of the directors were independent of Kalanick, the sole director that the Chancery Court found to have an interest.[43] Noting that it was reviewing the matter *de novo*, the Supreme Court, like the Chancery Court, applied the *Rales* test to assess whether the plaintiff's allegations created a reasonable doubt that the board could have properly exercised its disinterested and independent judgment.[44]

Director Disinterestedness

In light of Uber's exculpatory clause, the Court noted, the plaintiff was required to plead with particularity that the directors' breach of their duty of care amounted to bad faith—that is, they acted with knowledge that their conduct was legally improper.[45] In other words, to adequately plead that a director acted in bad faith, the plaintiff would be required to prove that the director acted inconsistently with his duties—and knew he was so acting. The Supreme Court noted that the plaintiff had attempted to impugn the disinterestedness of five of the eleven members of the Demand Board who had either approved the Otto acquisition or allowed it to close, but ultimately agreed with the Chancery Court that the plaintiff had only successfully pled that Kalanick had a disabling interest.[46]

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The Court rejected the plaintiff's argument that "the directors should have been wise enough not to rely on someone with a reputation as a law breaker," as well as the plaintiff's argument that the board, due to the merger agreement's allegedly "unusual" indemnification provisions, should have been on notice "that Kalanick wanted to steal Google's proprietary information."[47] The Court concluded that the plaintiff had failed to meet its "high hurdle" of showing bad faith, which it characterized as requiring a showing of "intentional wrongdoing."[48] The Court noted that the plaintiff's complaint alleged that the directors received a presentation summarizing the transaction, reviewed litigation risks, and discussed diligence—all of which was more than a "rubber-stamp."[49] Moreover, while the Court observed that Kalanick's background might "lead a reasonable board member to dig deeper into representations he made about the transaction," the Court nonetheless concurred with the Chancery Court's conclusion that there were no allegations that he had a history of lying to the board or that the board deliberately ignored due diligence risks.[50] As to the "unique" indemnification provisions, the Court found that the plaintiff's allegations did not lead to the inference that the directors "knew the transaction was nothing more than a vehicle to steal Google's proprietary information," but rather that the board perhaps should have done more.[51]

Regarding the plaintiff's analogies to the executive compensation cases, the Supreme Court, like the Chancery Court, found that the plaintiff had not pled that the directors devoted "very little time, had no presentations, and asked no questions," such that the failure to investigate could be characterized as an "intentional dereliction" of their duties.[52] For similar reasons, the Court rejected the plaintiff's argument that the directors who allegedly failed to thwart the transaction's closing acted in bad faith. The Court found that the plaintiff had not alleged that those directors were informed of any additional reason to doubt the integrity of the due diligence since the time the transaction was initially approved, and that directors in fact engaged in a discussion regarding risks of the transaction—all of which undermined the plaintiff's assertion that the directors "closed their eyes" to evidence that the transaction could involve a misappropriation of intellectual property.[53]

Director Independence

As to director independence, the Supreme Court, as did the Chancery Court, found that the defendants' motion to dismiss would hinge on whether a majority of the directors were independent of the one director, Kalanick, who had an interest. The Supreme Court likewise noted that the Demand Board consisted of 11 directors, and that the plaintiff did not challenge the independence of three of those directors and challenged the independence of two additional directors only vis-à-vis persons other than Kalanick who were found not to have a disabling interest. Thus, the Supreme Court noted that the existence of one additional independent director would be sufficient to overcome the plaintiff's pleading of demand futility.[54]

Here, the Supreme Court started with its analysis of the plaintiff's allegations in respect of John Thain. The Court agreed with the Chancery Court's determination that, despite the fact that Kalanick appointed Thain to the board in the midst of a control dispute, there were no allegations that Thain had a personal or financial connection to Kalanick or that Thain's appointment to the board was of any significance to him personally. The Court specifically commented on the nature of Thain's appointment, stating that Kalanick's designation of Thain, in and of itself, did not result in a reasonable inference that their relationship was of a "bias-producing nature." If that were the case, the Court noted, a director would be automatically disqualified merely by virtue of his or her appointment.

Takeaways

The opinion of the Chancery Court in *Kalanick* and the Supreme Court's affirmance of its ruling underscore the heightened pleading burdens that plaintiffs will face when seeking to call into question

the disinterestedness and independence of directors. In this case, the Chancery Court noted that the plaintiff did not make a books and records demand under Section 220 before filing their complaint. Although not expressly referenced in the opinion, the lack of books and records likely made the plaintiff's burden of pleading claims beyond mere conclusory allegations all the more difficult. Moreover, as the Chancery Court expressly noted, the plaintiff's failure to pursue a books and records demand made it far more difficult for the plaintiff to show the types of process-oriented omissions that have led to a pleading-stage finding of bad faith in other cases where the plaintiffs proceeded on a more robust record.

Directors will not be subjected to a heightened duty of care solely because they failed to 'dig deeper.'

The opinions also suggest that directors will not be effectively subjected to a heightened duty of care solely because they failed to "dig deeper" when receiving reports from members of management who are alleged to have a history of some type of misconduct or to be of "bad character." Nevertheless, the Chancery Court did indicate that, consistent with prior cases, if the directors were aware of manifest and pervasive law-breaking in a particular area, that prior conduct could serve as a red flag when directors are considering matters within that area. Thus, when considering topics as to which the company or any officer has been alleged or found to have engaged in some type of misconduct, directors should be particularly sensitive to process-oriented issues. They should ensure not only that they ask questions and seek to review materials, but also that the minutes recording their deliberations, and the materials they receive, are accurate and complete, reflecting both their further inquiries into areas of concern and the manner in which those concerns were addressed.

In addition, the Chancery Court indicated that certain areas, such as executive compensation, by their nature are sufficient to alert directors to the danger of deferring solely to management. While the board generally is permitted to rely on reports of officers and generally is fully protected in discharging its duty of care when so relying, directors should be particularly sensitive to the need for outside independent guidance and reports in circumstances where potential structural conflicts vis-à-vis management are present.

Notes

1. McElrath v. Kalanick, --- A.3d ---, 2020 WL 131371 (Del. Jan. 13, 2020).
2. McElrath v. Kalanick, 2019 WL 1430210 (Del. Ch. Apr. 1, 2019).
3. *Kalanick*, 2020 WL 131371, at *1.
4. *Kalanick*, 2019 WL 1430210, at *1.
5. As noted in the Chancery Court's opinion, Uber's recruitment of Levandowski commenced while Levandowski was still a Google employee, and after his resignation from Google, Levandowski exchanged text messages with Kalanick discussing potentially poaching Google employees. *Id.* at *3. As the Court also noted, in the less than one-month period after Levandowski left Google, Otto hired dozens of former Google employees. "At the time it was acquired, Otto operated out of Levandowski's house and had no real operations. Kalanick testified in a different litigation that '[Uber] basically [was] hiring [Levandowski] and his team.'" *Id.*
6. The Court stated that "[a]t a March 11, 2016 meeting, Levandowski told Kalanick and other Uber executives that he possessed proprietary and confidential information on Google's self-driving vehicle technology on his personal storage device or disks," but noted that Kalanick told Levandowski that "'he wanted nothing to do with the disks.'" *Id.* at *4.
7. *Id.*
8. *Id.*
9. The Court noted that one director testified in a different litigation that "'[t]here was a discussion about the indemnity'" and that it was atypical, which in turn led to a discussion regarding the diligence, and that the board determined to proceed on the basis that "'the due diligence was okay.'" *Id.*

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10. *Id.* at *6.
11. *See* 8 *Del. C.* § 220.
12. *Kalanick*, 2019 WL 1430210, at *1, *7, *12.
13. *Id.* at *10. The Court noted that Kalanick, as a director, would be entitled to benefit from the exculpatory provision Uber adopted pursuant to Section 102(b)(7) of the Delaware General Corporation Law, as would all other directors in their capacity as such, but that he would not be so protected in his capacity as an officer. *Id.*
14. *Id.* at *2.
15. *Id.* at *8.
16. Rales v. Blasband, 634 A.2d 927 (Del. 1993).
17. *Id.* The Court noted the "application of *Rales* depends on context," stating that the traditional test set forth in *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984), applies where "'a decision of the board of directors is being challenged in the derivative suit'"—in other words, when the business decision at issue is 'an action taken by the board that would consider the demand.'" The *Rales* test applies where "'the board that would be considering the demand did not make a business decision which is being challenged in the derivative suit,'" which includes the situations where (i) a majority of the directors who made the challenged decision have been replaced and (ii) members who served on the board at the time the decision was made remain but are in the minority. *Id.*
18. *Id.*
19. *Id.* at *9–10.
20. *Id.* at *10.
21. *Id.* at *10.
22. In re Caremark International Inc. Derivative Litigation, 698 A.2d 959, 961 (Del. Ch. 1996).
23. Specifically, the Court noted that the plaintiff analogized his claims to those at issue in *In re Massey Energy Co.*, 2011 WL 2176479 (Del. Ch. May 31, 2011). In that case, the Court declined to dismiss claims that the director-defendants had breached their duty of loyalty by knowingly causing the company to seek profit by violating the law and stated that "[Massey's] directors and officers cannot take comfort in the appearance of compliance motion at the pleading stage, when the plaintiffs are able to plead particularized facts creating an inference that the Board and management were aware of a troubling continuing pattern of non-compliance in fact and of a managerial attitude suggestive of a desire to fight with and hide evidence from the company's regulators." *Id.* at *21.
24. *Kalanick*, 2019 WL 1430210, at *13. The Court rejected the plaintiff's attempt to rely on Kalanick's involvement in a pre-Uber venture in which he was implicated in copyright infringement, noting that the plaintiff had not pled, nor could the Court reasonably infer, that the board had knowledge of that conduct.
25. *Id.* at *13.
26. "Not only is such lawbreaking activity, again, unrelated to the acquisition of Otto, but it also speaks only to the manner in which Uber and Kalanick dealt with *third parties*. The Plaintiff, however, does not allege that Kalanick had a history of deception when it came to Uber's own Board." *Id.* at *15 n.173 (emphasis in original).
27. *Id.* at *14.
28. *Id.*
29. *Id.* at *15.
30. *Id.* at *16. The Court also rejected the allegation that the board breached its duties by allowing the transaction to close despite the fact that the final Stroz report included information showing that Otto breached its representations, giving rise to a termination right on the part of Uber. Again, these alleged failings constituted at best exculpated breaches of the duty of care, but did not amount to bad faith. The Court also rejected the plaintiff's claims for waste. *Id.*
31. *Id.* at *17.
32. *Id.*
33. Id. at *17–18.
34. *Id.* at *18.
35. *Id.*
36. *Id.*
37. *Id.* at *19.
38. *Id.*
39. *Id.*
40. Once it concluded that Graves and Thain were independent, the Court concluded that a seven-member majority of the Demand Board was independent under *Rales*. *Id.*
41. *Id.*
42. *Id.* at *20.
43. McElrath v. Kalanick, --- A.3d ---, 2020 WL 131371, at *1 (Del. Jan. 13, 2020).

44. *Id.* at *4.
45. *Id.* at *5.
46. *Id.*
47. *Id.* at *6.
48. *Id.*
49. *Id.*
50. *Id.* at *7.
51. *Id.*
52. *Id.*
53. *Id.*
54. *Id.* at *8.

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