SUPREME COURT OF THE STATE OF NEW YORK
NEW YORK COUNTY

PRESENT: RAMOS Justice

PART 53

Index Number : 655205/2017
SOLAK, JOHN
vs.
FUNDARO, PAOLO
SEQUENCE NUMBER : 001
MOTION TO DISMISS

INDEX NO. _____

MOTION DATE _____

MOTION SEQ. NO. _____

The following papers, numbered 1 to _____, were read on this motion to/for _____

Notice of Motion/Order to Show Cause — Affidavits — Exhibits _____ No(s). _____

Answering Affidavits — Exhibits _____ No(s). _____

Replying Affidavits _____ No(s). _____

Upon the foregoing papers, it is ordered that this motion is

granted in accordance with the following memorandum.

MOTION/CASE IS RESPECTFULLY REFERRED TO JUSTICE FOR THE FOLLOWING REASON(S):

Dated: 03/19/18

_____, J.S.C.
CHARLES E. RAMOS

1. CHECK ONE: ..... ☒ CASE DISPOSED ☐ NON-FINAL DISPOSITION
2. CHECK AS APPROPRIATE: .....MOTION IS: ☒ GRANTED ☐ DENIED ☐ GRANTED IN PART ☐ OTHER
3. CHECK IF APPROPRIATE: ..... ☐ SETTLE ORDER ☐ SUBMIT ORDER
☐ DO NOT POST ☐ FIDUCIARY APPOINTMENT ☐ REFERENCE

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: COMMERCIAL DIVISION

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JOHN SOLAK, derivatively on behalf of INTERCEPT PHARMACEUTICALS, INC.,

Plaintiff,

-against-

Index No. 655205/2017

PAOLO FUNDARO, MARK PRUZANSKI M.D., SRINIVAS AKKARAJU M.D. Ph.D., LUCA BENATTI Ph.D., DANIEL BRADBURY, KEITH GOTTESDIENER M.D., GINO SANTINI, GLENN SBLENDORIO, and DANIEL WELCH,

Defendants,

-and-

INTERCEPT PHARMACEUTICALS, INC.,

Nominal Defendant.

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Hon. C. E. Ramos, J.S.C.:

In motion sequence 001, nominal defendant Intercept Pharmaceuticals, Inc. (Intercept) and defendants Paolo Fundaro, Mark Pruzanski M.D., Srinivas Akkaraju M.D. Ph.D., Luca Benatti Ph.D., Daniel Bradbury, Keith Gottesdiener M.D., Gino Santini, Glenn Sblendorio and Daniel Welch (together with Intercept, the Defendants) move to dismiss the Verified Shareholder Derivative Complaint (the Complaint) with prejudice pursuant to the Delaware Court of Chancery Rule 23.1, CPLR 3211(a)(1), and CPLR 3211(a)(7).

For the reasons set forth below, the motion to dismiss is granted, and the Complaint is dismissed in its entirety with prejudice.

Background

This is a stockholder derivative action brought on behalf of Intercept by John Solak, a resident of the State of New York and a shareholder of Intercept (Complaint, ¶ 6). Intercept is a biopharmaceutical company focusing on the development and commercialization of therapeutics to treat non-viral, progressive liver diseases (*Id.*, at ¶ 7). It is a Delaware corporation with its corporate headquarters in New York (*Id.*). Intercept's current board of directors (the Board) consists of the individuals named as Defendants (*Id.*, at ¶¶ 8-16, 34). All but Pruzanski are independent directors (*Id.*).

In February 2016, the Board adopted a revised non-employee director compensation policy (the 2016 Policy) (Complaint, ¶ 25). The 2016 Policy was effective as of the date of its adoption and was not approved by the shareholders of Intercept (the Shareholders) (*Id.*). Under the 2016 Policy, the compensation of each non-employee director consisted of: (I) a $50,000 annual cash retainer; (ii) an award of $232,045 in options to purchase shares of Intercept common stock; and (iii) an award of $174,787 in shares of restricted stock (*Id.*, at ¶ 26). Additionally, non-employee directors acting as Chair of the Board or of any Board committee are eligible for additional fees of up to $25,000 per director, and other members of committees receive fees of up to $10,000 per committee (*Id.*). Newly appointed non-employee

directors are also entitled to a non-qualified stock option grant under Intercept's 2012 Equity Incentive Plan (the 2012 Plan) to purchase shares of Intercept common stock equivalent to $464,090 in value, and shares of restricted stock equivalent to $349,575 in value (*Id.*).

On March 10, 2017, Solak, by his attorneys, sent a letter to the Board (the Letter) regarding the excessive levels of the non-employee directors' compensation, requesting that the Board, within 30 days, take:

> all action necessary actions [sic], including revising the awards of options and restricted stock and cancelling any option and restricted stock awards granted under the Policy until a newly-revised director compensation plan may be proposed by [Intercept] and reviewed, considered and approved by shareholders prior to its adoption (Complaint, Ex. B).

On March 28, 2017, Intercept, by its attorneys, responded in writing, stating that "[w]e will be in further contact with you with respect to the Board's consideration of the [Letter] as and when appropriate" (Complaint, Ex. C).

In April 2017, the Board adopted a revised non-employee director compensation policy (the 2017 Policy), which was not presented to or approved by the Shareholders prior to its adoption (Complaint, ¶ 39). Under the 2017 Policy, the compensation of each non-employee director consisted of: (I) a $50,000 annual cash retainer; (ii) an award of $163,616 in options to purchase shares of Intercept common stock; and (iii)

an award of $173,587 in shares of restricted stock (*Id.*, at 40). Additionally, non-employee directors acting as Chair of the Board or any Board committee would be eligible for additional fees of up to $30,000 per director, and other committee members would receive fees of up to $10,000 per committee (*Id.*). Further, newly-appointed non-employee directors would be entitled to a non-qualified stock option grant under the 2012 Plan to purchase shares of Intercept common stock equivalent to $369,823 in value, and shares of restricted stock equivalent to $323,638 in value (*Id.*).

The Board responded to the Letter via letter dated July 5, 2017 from attorney Edward B. Micheletti (the Response) (Complaint, ¶ 42). In the Response, the Board stated that it conducted a factual investigation by reviewing pertinent documents and interviewing the Compensation Committee and Radford, an independent consultant (Complaint, Ex. D). The Board further stated that the allegations in the Letter would have an "extremely low probability of success on the merits," and concluded that it would not be in the best interest of Intercept to take any action beyond the usual review of Intercept's policies (*Id.*). Solak replied to the Response by letter dated July 10, 2017, asking to discuss the issues raised in the Letter with the Board (Complaint, ¶ 47). Solak also notably stated that the Letter was not a demand for litigation, and that he did not

request Intercept to bring suit against the Board (Complaint, Ex. E).

On August 4, 2017, Solak started this action, derivatively on behalf of Intercept, alleging claims for breach of the fiduciary duties of loyalty and good faith, waste of corporate assets, and unjust enrichment. On September 25, 2017, the Defendants moved to dismiss the Complaint in its entirety, with prejudice.

Discussion

1. Applicability of Delaware Law

"New York choice-of-law rules provide that substantive issues such as issues of corporate governance, including the threshold demand issue, are governed by the law of the state in which the corporation is chartered" (*Lerner v Prince*, 119 AD3d 122, 128 [1st Dept 2014]). Intercept is incorporated in Delaware, and therefore Delaware law governs this action. Under Delaware law, a dispute related to a shareholder derivative action, and the conditions under which such action is possible, is governed by Rule 23.1 of the Delaware Chancery Court Rules (Rule 23.1). One of those conditions is the demand requirement, according to which a shareholder must exhaust corporate remedies before bringing a derivative suit (*Aronson v Lewis*, 473 A2d 805, 812-13 [Del 1984]). Issues related to the demand requirement under Rule

23.1 are substantive rather than procedural (*Kamen v Kemper Financial Services, Inc.*, 500 US 90, 96-97 [1991]).

2. **Qualification of the Letter as a Rule 23.1 Demand**

Solak seeks to bring a derivative action on behalf of Intercept for breach of the fiduciary duties of loyalty and good faith, waste of corporate assets, and unjust enrichment (Complaint, ¶ 53-70). However, a shareholder may not bring a derivative action until it has made a demand to the board of directors to take legal action and this demand was refused, or until it has demonstrated that such a demand would have been futile (*Ash v McCall*, No CivA 17132, 2000 WL 1370341, at *6 [Del Ch 2000]). The Defendants assert that the Letter is a demand for the purposes of Rule 23.1, and that the Board appropriately refused to bring a derivative suit in accordance with the business judgment rule. Solak maintains that the Letter does not constitute a Rule 23.1 demand, and that he was justified not to issue a Rule 23.1 demand because a demand would have been futile.

Under Delaware law, a communication is a demand under Rule 23.1 if it provides "(I) the identity of the alleged wrongdoers, (ii) the wrongdoing they allegedly perpetrated and the resultant injury to the corporation, and (iii) the legal action the shareholder wants the board to take on the corporation's behalf" (*Yaw v Talley*, 1994 WL 89019, at *7, *citing Allison on Behalf of General Motors Corp. v General Motors Corp.*, 604 FSupp 1106, 1117

[D Del 1985]) (applying Delaware law). The Board must have all the information necessary to assess whether the alleged wrong occurred and whether to take steps to rectify it (*Brook v Acme Steel Co.*, No 10276, 1989 WL 51674, at *2 [Del Ch 1989]). The burden of demonstrating that a communication constitutes a demand lies with the party alleging the communication should be viewed as such, and any ambiguity should be construed against a finding of demand (*Khanna v McMinn*, No CivA 20545-NC, 2006 WL 1388744, at *13 [Del Ch 2006]).

A communication will not constitute a demand if the communication was made to pursue personal benefits rather than corporate benefits (*Khanna v McMinn,* 2006 WL 1388744, at *13). In *Khanna*, the Chancery Court found that the communication was related to the plaintiff's removal from the company and his future employment, and consequently, was made for his personal benefit and did not constitute a demand (*Id.*). Likewise, in *Yaw*, the plaintiff was trying to get the directors to sell their shares as shareholders, which would have benefitted him personally rather than the company (*Yaw v Talley*, CivA No 12882, 1994 WL 89019, at *3, 8 [Del Ch 1994]). In this case, the Letter was not issued for personal benefit, and stated that it was made on behalf of and to protect the interests of Intercept and the Shareholders.

The Letter clearly identified (I) the alleged wrongdoers (the directors), and (ii) the alleged wrongdoing (the excessive compensation policy) and resultant injury to the company (unreasonable costs), fulfilling two of the *Yaw* criteria (*Yaw v Talley*, 1994 WL 89019, at *7). As to whether the Letter identified the third criterion, a legal action that Solak wanted the Board to take on Intercept's behalf, it states in relevant part:

> [W]e demand that the Board take all action necessary actions [sic], including revising the awards of options and restricted stock and cancelling any option and restricted stock awards granted under the Policy…[and, without a definitive response from the Board within 30 days, Solak will consider] available actions and remedies in order to compel the Board to act for the benefit of Intercept and its shareholders (Complaint, Ex. B.).

When the board is demanded to take "all action necessary" to revise the directors' compensation, this obviously includes taking requisite legal action to achieve the goal. Moreover, while some directors may have elected to cancel parts of their compensation when requested to do so, the Board would most likely need to have taken legal action to cancel options and restricted stock awards that had already been issued. Such a move would have ruffled feathers. The Letter does constitute a Rule 23.1 demand.

3. **Applicability of the Business Judgment Rule**

As the Board refused to take legal action requested in the Letter (Complaint, Ex. D), the Court must examine whether that

refusal was wrongful. In order to do so, the Court needs to determine which standard of review applies to the Board's decision. Defendants assert that the business judgment rule applies to a wrongful refusal analysis under Rule 23.1, and that Solak fails to allege facts sufficient to rebut the business judgment rule.

Solak argues that the Letter is not a Rule 23.1 demand and that the entire fairness standard should be applied in place of the business judgment rule. The entire fairness standard "requires the board of directors to establish to the court's satisfaction that the transaction was the product of both fair dealing and fair price" (*Cinerama, Inc. v Technicolor, Inc.*, 663 A2d 1156, 1163 [Del 1995]) (internal citation omitted). The entire fairness standard applies when a stockholder rebuts the business judgment rule (*Calma on Behalf of Citrix Systems, Inc. v Templeton*, 114 A3d 563, 577 [Del Ch 2015]). Solak relies on the case of *Calma on Behalf of Citrix Systems, Inc. v Templeton*, 114 A3d at 578 to argue that the business judgment rule should not apply to the Board's compensation decision because "director self-compensation decisions are conflicted transactions that lie outside the business judgement rule's presumptive protection." In *Calma*, however, the plaintiff did not make a demand on the board to litigate because it alleged that a demand would be futile, so

a derivative claim was brought directly to the court (*Id.*). As Solak did make a demand, this case is inapplicable.

The decision to bring a lawsuit or refrain from litigation is a decision concerning the management of the corporation, which is evaluated based on the business judgment rule (*Spiegel v Buntrock*, 571 A2d 767, 773-74 [Del 1990]). The rule is "a presumption that in making a business decision, not involving self-interest, the directors of a corporation acted on an informed basis in good faith and in the honest belief that the action taken was in the best interests of the company" (*Friedman v Maffei*, No. 11105-VCMR, 2016 WL 1555331, at *8 [Del Ch 2016]). The plaintiff can rebut the business judgment rule by alleging "particularized facts that raise a reasonable doubt as to whether the board's decision to refuse the demand was the product of valid business judgment" (*Id.*). A party arguing against the application of the business judgment rule has the burden of showing that the board breached its duty of care or loyalty, or acted in bad faith (*In re Walt Disney Co. Derivative Litigation*, 906 A2d 27, 52 [Del 2006]). The burden then shifts to the board to demonstrate that "the challenged act or transaction was entirely fair to the corporation and its shareholders" (*Id.*).

In the context of the analysis of a board's decision to refuse a Rule 23.1 demand, the test is modified because a plaintiff making a Rule 23.1 demand to the board concedes that

the board is disinterested and independent for the purpose of responding to the demand, meaning that the board did not breach its duty of loyalty (*Andersen v Mattel, Inc.*, No. 11816-VCMR, 2017 WL 218913, at *3 [Del Ch 2017]). Solak made a demand to the Board to take action in accordance with Rule 23.1, and therefore conceded that the Board was independent and disinterested (*Id.*). Solak also acknowledged this in the Letter (Complaint, Ex. B.) (stating that "[c]onsidering the current make-up of the Board, we trust the Board will respond to this demand independently and impartially on behalf of [Intercept]").

To rebut the business judgment rule in the context of a Rule 23.1 demand, a party must:

> allege particularized facts that raise a reasonable doubt that (1) the board's decision to deny the demand was consistent with its duty of care to act on an informed basis, that is, was not grossly negligent; or (2) the board acted in good faith, consistent with its duty of loyalty (*Friedman v Maffei*, 2016 WL 1555331, at *9).

To demonstrate those elements, plaintiffs are entitled to all reasonable factual inferences that logically flow from the particularized facts alleged (*Brehm v Eisner*, 746 A2d 244, 255 [Del 2000]). However, conclusory allegations are not sufficient (*Id.*).

Solak fails to allege with particularized facts that the Board was grossly negligent. To demonstrate that the board acted with gross negligence, a plaintiff must allege that the board failed "either to investigate the demand at all or in pursuing

such an inadequate investigation, in light of the seriousness of the demand, [...] a court may reasonably infer a breach of the duty of care" (*Ironworkers District Council of Philadelphia & Vicinity Retirement & Pension Plan v Andreotti*, No 9714-VCG 2015, WL 2270673, at *26 [Del Ch 2015]). The directors must reasonably inform themselves with all material information reasonably available (*Cede & Co. v Technicolor, Inc.*, 634 A2d 345, 367 [Del 1993]). Only when the directors fail to inform themselves fully and in a deliberate manner before voting will the court consider that the board breached its duty of care (*Id.*, at 368).

Nor has Solak presented any facts to show that the Board breached its duty of care in the Complaint. On the contrary, the Response details the actions taken by the Board (Complaint, Ex. D). The Board retained a law firm, met several times to discuss how to respond to the Letter, reviewed pertinent public and private documents, and interviewed Radford and directors of the Compensation Committee who have "decades of collective experience in the Company's industry and as members of compensation committees of other companies" (*Id.*). The Board also studied the compensation of directors in other supposedly similar companies (the Peer Group). The fifteen companies in the Peer Group were selected by Radford, and approved by the Compensation Committee.

Solak disputes the legitimacy of the Peer Group because most of its members are also Radford's clients. It further alleges

that the companies in the Peer Group are not similar to Intercept, so any comparison is not relevant. While the Response states that the Peer Group is composed of "comparable publicly-traded biotechnology companies similar to Intercept in several ways, including stage of development, market capitalization and number of employees" (Complaint, Ex. D), Solak alleges that the Board should have selected companies by using different criteria, such as revenue and profit (Complaint, ¶ 2). However, the fact that Solak would have used a different peer group is not sufficient for us to determine that the Board's investigation was so inadequate that gross negligence could reasonably be inferred.

When directors reasonably believe that the information on which they rely "has been presented by an expert selected with reasonable care and is within that person's professional or expert competence," they are entitled to the protection granted by Section 141(e) of the General Corporation Law of Delaware (Section 141(e)) (*Crescent/Mach I Partners, L.P. v Turner*, 846 A2d 963, 985 [Del Ch 2000]). Section 141(e) states:

> (e) A member of the board of directors, or a member of any committee designated by the board of directors, shall, in the performance of such member's duties, be fully protected in relying in good faith upon […] such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation (8 Del.C. 141(e)).

The Board based its decision not to take action on the Peer Group analysis that was provided by Radford and approved by the Compensation Committee. The Board's decision is therefore protected by Section 141(e).

To rebut the protection of Section 141(e), a plaintiff would need to show that the directors were grossly negligent in relying on the expert (*Crescent/Mach I Partners, L.P. v Turner*, 846 A2d at 985). According to the Supreme Court of Delaware:

> To survive a Rule 23.1 motion to dismiss in a due care case where an expert has advised the board in its decisionmaking process, the complaint must allege particularized facts (not conclusions) that, if proved, would show, for example, that: (a) the directors did not in fact rely on the expert; (b) their reliance was not in good faith; © they did not reasonably believe that the expert's advice was within the expert's professional competence; (d) the expert was not selected with reasonable care by or on behalf of the corporation, and the faulty selection process was attributable to the directors; (e) the subject matter…that was material and reasonably available was so obvious that the board's failure to consider it was grossly negligent regardless of the expert's advice or lack of advice; or (f) that the decision of the Board was so unconscionable as to constitute waste or fraud (*Brehm v Eisner*, 746 A2d at 262).

The Complaint fails to show that Radford was not an expert competent to deal with compensation matters, that the Board's reliance was not in good faith, or that the Board was grossly negligent in any other way.

Finally, Solak also fails to rebut the business judgment rule by failing to allege with particularized facts that the Board acted in bad faith. To sufficiently plead bad faith, a plaintiff must argue that a decision is "so inexplicable that a

court may reasonably infer that the directors must have been acting for a purpose unaligned with the best interest of the corporation; that is, in bad faith" (*Ironworkers District Council of Philadelphia & Vicinity Retirement & Pension Plan v Andreotti*, No 9714-VCG, 2015 WL 2270673, at *26 [Del Ch 2015]). The Board's decision not to take legal action was justifiably based on "an extremely low probability of success on the merits" (Complaint, Ex. D). The Board explained that the processes used to decide the calculation of and non-employee directors' compensation were entirely fair to Intercept, that an action would carry significant costs for limited awards, and that the Board relied in good faith on the Compensation Committee and on Radford's recommendations (*Id.*). The Board also relied on an expert, Radford, and the Compensation Committee, to decide the compensation of non-employee directors. Solak fails to provide any reason why the Board should not have followed Radford's compensation advice. Solak fails to allege that the Board acted in bad faith.

Under the business judgment rule, courts must give deference to directors' decisions (*Brazen v Bell Atlantic Corp.*, 695 A2d 43, 49 [Del 1997]), and may not substitute their business judgment for that of the Board (*Orman v Cullman*, 794 A2d 5, 20 [Del Ch 2002]). Having failed to demonstrate that the Board's refusal to take legal action was grossly negligent or in bad

faith, Solak cannot bring a derivative action on behalf of Intercept. This Court must respect the Board's decision and award it the protection of the business judgment rule.

Accordingly, it is

ORDERED that the Complaint is dismissed in its entirety with prejudice and the Clerk is directed to enter judgment accordingly.

Date: March 19, 2018

Enter:

J.S.C.

CHARLES E. RAMOS