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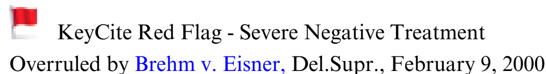
KeyCite Red Flag - Severe Negative Treatment
Overruled by Brehm v. Eisner, Del.Supr., February 9, 2000

673 A.2d 1207
Supreme Court of Delaware.

C.L. **GRIMES**, Plaintiff Below, Appellant,
v.
James L. **DONALD**, Clement M. Brown, Jr., Frank J. Cummiskey, Raymond J. Dempsey, John Fairclough, James L. Fischer, Robert S. Folsom, James P. Leake, James M. Nolan, and Jim A. Watson, Defendants Below, Appellees,
and
DSC Communications Corporation, Nominal Defendant Below, Appellee.

No. 791995.
|
Submitted: Jan. 25, 1996.
|
Decided: April 11, 1996.

Synopsis
Stockholder brought suit against board of corporation, challenging employment agreements entered into with chief executive officer (CEO). The Chancery Court, New Castle County, dismissed suit and appeal was taken. The Supreme Court, Veasey, C.J., held that: (1) board had not abdicated its responsibility to manage corporation by entering into employment agreements with CEO allowing him to unilaterally terminate contract if he believed that board has been interfering with his management, and obtain severance benefits of up to $20 million, even though shareholder claimed that fear of termination precluded board from supervising CEO; (2) stockholder could not demand that board abrogate agreements on grounds that they delegated board's management responsibility to CEO and then claim that demand was excused on related claims that agreements involved corporate waste and excessive compensation; and (3) stockholder had failed to plead with particularity why board's refusal to act on derivative claims was wrong.

Affirmed.

West Headnotes (17)

[1] **Corporations and Business Organizations**

Persons entitled to sue;standing

101 Corporations and Business Organizations
101VII Directors, Officers, and Agents
101VII(D) Rights, Duties, and Liabilities as to Corporation and Its Shareholders or Members
101k1929 Actions Between Shareholders or Members and Directors, Officers, or Agents
101k1933 Persons entitled to sue; standing
(Formerly 101k320(6))

To pursue “direct action” against board, shareholder must allege more than injury resulting from wrong to corporation, but must also state claim for injury separate and distinct from that suffered by other shareholders, or a wrong involving contractual right of shareholder, which exists independently of any right of corporation.

24 Cases that cite this headnote

[2] **Corporations and Business Organizations**

Bill, petition, or complaint

101 Corporations and Business Organizations
101VII Directors, Officers, and Agents
101VII(D) Rights, Duties, and Liabilities as to Corporation and Its Shareholders or Members
101k1929 Actions Between Shareholders or Members and Directors, Officers, or Agents
101k1937 Pleading
101k1937(2) Bill, petition, or complaint
(Formerly 101k320(6))

Pleading requirements for making a direct claim by shareholder against board of directors may be satisfied by a “short and plain statement of the claim.” Chancery Court Rule 12(b)(6).

6 Cases that cite this headnote

[3] **Pretrial Procedure**

Construction of pleadings

Pretrial Procedure

Fact questions

307A Pretrial Procedure
307AIII Dismissal
307AIII(B) Involuntary Dismissal
307AIII(B)6 Proceedings and Effect
307Ak679 Construction of pleadings
307A Pretrial Procedure
307AIII Dismissal
307AIII(B) Involuntary Dismissal
307AIII(B)6 Proceedings and Effect
307Ak680 Fact questions

In considering motion to dismiss claim brought by shareholder of corporation directly against board, Court of Chancery assumes truth of well-pleaded allegations, giving to plaintiff benefit of all reasonable inferences that can be drawn from pleading. Chancery Court Rule 12(b)(6).

11 Cases that cite this headnote

[4] **Pretrial Procedure**

Construction of pleadings

307A Pretrial Procedure
307AIII Dismissal
307AIII(B) Involuntary Dismissal
307AIII(B)6 Proceedings and Effect
307Ak679 Construction of pleadings

Conclusory statements without supporting factual averments will not be accepted as true for purposes of motion to dismiss direct claim brought by shareholders of corporation against board. Chancery Court Rule 12(b)(6).

6 Cases that cite this headnote

[5] **Appeal and Error**

De novo review

30 Appeal and Error
30XVI Review
30XVI(D) Scope and Extent of Review
30XVI(D)3 Procedural Matters in General
30k3196 Dismissal and Nonsuit in General
30k3200 De novo review
(Formerly 30k893(2))

Supreme Court reviews de novo decision by Court of Chancery on motion to dismiss claim brought directly against board of directors by shareholder, applying same legal standard as used by Court of Chancery. Chancery Court Rule 12(b)(6).

3 Cases that cite this headnote

[6] **Corporations and Business Organizations**

Severance Plans and Agreements

101 Corporations and Business Organizations
101VII Directors, Officers, and Agents
101VII(D) Rights, Duties, and Liabilities as to Corporation and Its Shareholders or Members
101k1812 Compensation and Benefits
101k1819 Severance Plans and Agreements
101k1819(1) In general
(Formerly 101k308(9))

Board of directors had not abdicated its ability to manage or direct management of corporation by entering into employment agreements with chief executive officer (CEO) allowing CEO to unilaterally declare contract terminated without cause if board unreasonably interfered with his management of corporation, triggering right of CEO to obtain severance benefits of up to $20 million; considering size of corporation $20 million was not so prohibitive as to mandate conclusion that board had de

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facto abdicated its management role, on grounds that termination would be so costly that board would not in fact supervise CEO, and present marketplace for CEO required grant of substantial benefits to attract qualified persons.

8 Cases that cite this headnote

[7] **Corporations and Business Organizations**
Necessity of demand
Corporations and Business Organizations
Excuse for Failure to Demand; Futility

101 Corporations and Business Organizations
101VIII Derivative Actions;Suing or Defending on Behalf of Corporation
101VIII(A) In General
101k2035 Demanding Action and Refusal of Corporation, Directors or Officers to Act
101k2037 Necessity of demand
(Formerly 101k206(2))
101 Corporations and Business Organizations
101VIII Derivative Actions;Suing or Defending on Behalf of Corporation
101VIII(A) In General
101k2035 Demanding Action and Refusal of Corporation, Directors or Officers to Act
101k2040 Excuse for Failure to Demand;Futility
101k2040(1) In general
(Formerly 101k206(4))

Shareholder filing derivative suit must allege either that board rejected his pre-suit demand that board assert corporation's claim or allege with particularity why stockholder was justified in not having made effort to obtain board action.

18 Cases that cite this headnote

[8] **Corporations and Business Organizations**
Interest of director or officer in lawsuit or lack of independence

101 Corporations and Business Organizations
101VIII Derivative Actions;Suing or Defending on Behalf of Corporation
101VIII(A) In General
101k2035 Demanding Action and Refusal of Corporation, Directors or Officers to Act
101k2040 Excuse for Failure to Demand;Futility
101k2040(2) Interest of director or officer in lawsuit or lack of independence
(Formerly 101k206(4))

Stockholder desiring to bring derivative suit on behalf of corporation may do so without making demand on board to bring action, on grounds that demand would be futile, if reasonable doubt exists that board is capable of making an independent decision to assert claim if demand were made.

33 Cases that cite this headnote

[9] **Corporations and Business Organizations**
Excuse for Failure to Demand; Futility
Corporations and Business Organizations
Interest of director or officer in lawsuit or lack of independence

101 Corporations and Business Organizations
101VIII Derivative Actions;Suing or Defending on Behalf of Corporation
101VIII(A) In General
101k2035 Demanding Action and Refusal of Corporation, Directors or Officers to Act
101k2040 Excuse for Failure to Demand;Futility
101k2040(1) In general
(Formerly 101k206(4))
101 Corporations and Business Organizations

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101VIII Derivative Actions;Suing or Defending on Behalf of Corporation
101VIII(A) In General
101k2035 Demanding Action and Refusal of Corporation, Directors or Officers to Act
101k2040 Excuse for Failure to Demand;Futility
101k2040(2) Interest of director or officer in lawsuit or lack of independence
(Formerly 101k206(4))

Stockholder will be excused from requirement that demand be made on board of directors before instituting suit on behalf of corporation when (1) majority of board has material financial or familial interest in matter in question, (2) majority of board is incapable of acting independently for some other reason such as domination or control, or (3) underlying transaction is not product of valid exercise of business judgment.

29 Cases that cite this headnote

[10] **Corporations and Business Organizations**
Excuse for Failure to Demand; Futility
Corporations and Business Organizations
Interest of director or officer in lawsuit or lack of independence

101 Corporations and Business Organizations
101VIII Derivative Actions;Suing or Defending on Behalf of Corporation
101VIII(A) In General
101k2035 Demanding Action and Refusal of Corporation, Directors or Officers to Act
101k2040 Excuse for Failure to Demand;Futility
101k2040(1) In general
(Formerly 101k206(4))
101 Corporations and Business Organizations
101VIII Derivative Actions;Suing or Defending on Behalf of Corporation
101VIII(A) In General
101k2035 Demanding Action and Refusal of Corporation, Directors or Officers to Act
101k2040 Excuse for Failure to Demand;Futility
101k2040(2) Interest of director or officer in lawsuit or lack of independence
(Formerly 101k206(4))

"Reasonable doubt" required to be established before stockholder seeking to bring derivative action on behalf of corporation may do so without first making demand upon board that it bring action, can be said to mean that there is reason to doubt that board is capable of making independent decision, or stated obversely, concept is akin to concept that stockholder had reasonable belief that board lacked independence or transaction was not protected by business judgment rule.

45 Cases that cite this headnote

[11] **Corporations and Business Organizations**
Sufficiency of Refusal

101 Corporations and Business Organizations
101VIII Derivative Actions;Suing or Defending on Behalf of Corporation
101VIII(A) In General
101k2035 Demanding Action and Refusal of Corporation, Directors or Officers to Act
101k2039 Sufficiency of Refusal
101k2039(1) In general
(Formerly 101k206(1))

Stockholder who makes demand that board of directors institute suit on behalf of corporation is entitled to know promptly what action board has taken in response to demand.

9 Cases that cite this headnote

[12] **Corporations and Business Organizations**
Sufficiency of Refusal

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101 Corporations and Business Organizations
101VIII Derivative Actions;Suing or Defending on Behalf of Corporation
101VIII(A) In General
101k2035 Demanding Action and Refusal of Corporation, Directors or Officers to Act
101k2039 Sufficiency of Refusal
101k2039(1) In general
(Formerly 101k206(1))

Stockholder who makes serious demand on board of directors that it institutes suit on behalf of corporation and receives only peremptory refusal has right to use "tools at hand," including public information, and stockholder's right to inspect corporate books and records, to determine whether or not there is basis to assert that demand was wrongfully refused. 8 Del.C. § 220.

14 Cases that cite this headnote

[13] Corporations and Business Organizations

Sufficiency of Refusal

101 Corporations and Business Organizations
101VIII Derivative Actions;Suing or Defending on Behalf of Corporation
101VIII(A) In General
101k2035 Demanding Action and Refusal of Corporation, Directors or Officers to Act
101k2039 Sufficiency of Refusal
101k2039(1) In general
(Formerly 101k206(1))

Corporation may not assume position of neutrality and take no position in response to demand by shareholder that board bring derivative action on behalf of corporation. 8 Del.C. § 220.

5 Cases that cite this headnote

[14] Corporations and Business Organizations

Sufficiency of Refusal

101 Corporations and Business Organizations
101VIII Derivative Actions;Suing or Defending on Behalf of Corporation
101VIII(A) In General
101k2035 Demanding Action and Refusal of Corporation, Directors or Officers to Act
101k2039 Sufficiency of Refusal
101k2039(1) In general
(Formerly 101k206(1))

Shareholder making demand on board to institute suit on behalf of corporation does not waive right to claim that demand has been wrongfully refused.

6 Cases that cite this headnote

[15] Corporations and Business Organizations

Presumptions and burden of proof

101 Corporations and Business Organizations
101VIII Derivative Actions;Suing or Defending on Behalf of Corporation
101VIII(A) In General
101k2055 Evidence
101k2057 Presumptions and burden of proof
(Formerly 101k212)

If demand is made by stockholder on board of directors, that board bring action on behalf of corporation, and board rejects demand, board is entitled to presumption of business judgment rule unless stockholder can allege facts with particularity creating reasonable doubt that board is entitled to benefit of presumption.

36 Cases that cite this headnote

[16] Corporations and Business Organizations

Excuse for Failure to Demand; Futility

101 Corporations and Business Organizations

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101VIII Derivative Actions;Suing or Defending on Behalf of Corporation
101VIII(B) Derivative Actions by Shareholders Against Directors, Officers, or Agents
101k2085 Demanding Action and Refusal of Corporation, Directors, or Officers to Act
101k2090 Excuse for Failure to Demand;Futility
101k2090(1) In general
(Formerly 101k320(5))

Stockholder who had made demand on board of directors that it abrogate employment contracts with chief executive officer (CEO), on grounds that agreements had effect of abdicating responsibility of board to manage corporation, could not subsequently claim that he was excused from demanding that board abrogate agreements on grounds that they constituted corporate waste and involved excessive compensation.

5 Cases that cite this headnote

[17] **Corporations and Business Organizations**
Sufficiency of allegations of demand and refusal

101 Corporations and Business Organizations
101VIII Derivative Actions;Suing or Defending on Behalf of Corporation
101VIII(B) Derivative Actions by Shareholders Against Directors, Officers, or Agents
101k2095 Pleading
101k2100 Sufficiency of allegations of demand and refusal
(Formerly 101k320(5))

Stockholder failed to plead with sufficient particularity facts in support of claim that board had wrongfully refused to take action demanded of it in connection with employment agreements involving chief executive officer (CEO); complaint had generally asserted that refusal could not have been result of adequate, good faith investigation, as board decided not to act on demand, and conclusory statements failed to raise reasonable doubt that board's decision was product of valid business judgment.

20 Cases that cite this headnote

***1209** Upon appeal from the Court of Chancery. **AFFIRMED.**

Court Below: Court of Chancery of the State of Delaware in and for New Castle County; C.A. No. 13358.

Attorneys and Law Firms

Clark W. Furlow (argued), of Smith, Katzenstein & Furlow, Wilmington, and Thaddeus Holt (argued), Point Clear, Alabama, for Appellant C.L. **Grimes**.

***1210** Robert K. Payson and Stephen C. Norman of Potter, Anderson & Corroon, Wilmington; Samara L. Kline (argued), of Baker & Botts, Dallas, TX, for appellee James L. **Donald**.

Thomas R. Hunt, Jr., Michael L. Vild, and Thomas C. Grimm of Morris, Nichols, Arsht & Tunnell, Wilmington, Chester A. Hinshaw (argued), of Jones, Day, Reavis & Pogue, Dallas, TX, for Appellees Clement M. Brown, Frank J. Cummiskey, Raymond J. Dempsey, John Fairclough, James L. Fischer, Robert S. Folsom, James P. Leake, James M. Nolan and Jim A. Watson.

Stephen E. Jenkins of Ashby & Geddes, Wilmington, for Appellee DSC Communications Corporation.

Before VEASEY, C.J., WALSH, HOLLAND, HARTNETT and BERGER, JJ. (constituting the Court en Banc).

Opinion

VEASEY, Chief Justice:

In this appeal we address the following issues: (1) the distinction between a direct claim of a stockholder and a derivative claim; (2) a direct claim

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of alleged abdication by a board of directors of its statutory duty; (3) when a pre-suit demand in a derivative suit is required or excused; and (4) the consequences of demand by a stockholder and the refusal by the board to act on such a demand.

We hold that the Court of Chancery correctly dismissed this stockholder action for the failure to state a claim upon which relief can be granted where the plaintiff stockholder: (a) asserted a direct claim that the directors abdicated their statutory duty to manage or direct the management of the business and affairs of the corporation by entering various employment contracts (the "Agreements") with the chief executive officer ("CEO") providing that the CEO "shall be responsible for the general management of the affairs of the company" and further providing that the CEO can declare a constructive termination of the Employment Agreement for "unreasonable interference" by the Board with the CEO; (b) made a pre-suit demand on the Board to abrogate the Agreements, the demand was refused, and the stockholder thereafter sought to assert other legal theories relating to the Agreements, arguing that demand was excused.

We hold as follows: First, an abdication claim can be stated by a stockholder as a direct claim, as distinct from a derivative claim, but here the complaint fails to state a claim upon which relief can be granted. Second, when a stockholder demands that the board of directors take action on a claim allegedly belonging to the corporation and demand is refused, the stockholder may not thereafter assert that demand is excused with respect to other legal theories in support of the same claim, although the stockholder may have a remedy for wrongful refusal or may submit further demands which are not repetitious.

Accordingly, on the state of this record, we **AFFIRM** the dismissal of this action by the Court of Chancery.

I. The Facts

C.L. Grimes ("Grimes"), plaintiff below-appellant, appeals from the dismissal, for failure to state a claim, of his complaint against James L. Donald ("Donald") (the CEO) and the Board of Directors (the "Board") of DSC Communications Corporation ("DSC" or the "Company"). Grimes seeks a declaration of the invalidity of the Agreements between Donald and the Company. He also seeks an award of damages against Donald and other members of the Board. He alleges that the Board has breached its fiduciary duties by abdicating its authority, failing to exercise due care and committing waste.

The following facts have been drawn from the face of the complaint. The Company is a Delaware corporation headquartered in Plano, Texas, a suburb of Dallas. The Company, whose shares are traded on the Nasdaq National Market System, designs, manufactures, markets and services telecommunication systems.

The Agreements, executed during 1990, are the focus of the complaint. The Employment Agreement provides that Donald "shall be responsible for the general management of the affairs of the company ...," and that Donald "shall report to the Board." The ***1211** Employment Agreement runs until the earlier of Donald's 75th birthday or his termination (1) by reason of death or disability; (2) for cause; or (3) without cause. Under the Employment Agreement, Donald can declare a "Constructive Termination Without Cause" by the Company of his employment as a result of, *inter alia,* "unreasonable interference, in the good-faith judgment of ... [Donald], by the Board or a substantial stockholder of the Company, in [Donald's] carrying out his duties and responsibilities under the [Employment] Agreement." A Constructive Termination Without Cause takes effect after delivery of notice by Donald and the failure by the Board to remedy such interference.

In the event of a Termination Without Cause, constructive or otherwise, Donald is entitled to the following:

1. Continued payment of his "Base Salary" at the level in effect immediately prior to termination for the remainder of his "Term of Employment," which, as stated, will be 6 ½ years unless Donald dies or turns 75 first. In 1992, Donald's Base Salary exceeded $650,000.

2. Annual incentive awards for the remainder of the Term of Employment equal to the average of the three highest annual bonuses awarded to **Donald** during his last ten years as CEO. In 1992, such award allegedly equaled $300,000.

3. Medical benefits for **Donald** and his wife for life, as well as his children until the age of 23.

4. Continued participation in all employee benefit plans in which **Donald** is participating on the date of termination until the earlier of the expiration of the Term of Employment or the date on which he receives equivalent benefits from a subsequent employer.

5. Other (unidentified) benefits in accordance with DSC's plans and programs. *See* Am.Cplt.Ex. 1 § 11(d).

***Grimes** v. **Donald**,* Del.Ch., 20 Del.J.Corp.L. 757, 765, 1995 WL 54441 (1995).

The Income Continuation Plan provides, *inter alia,* that after Base Salary payments cease under the Employment Agreement, **Donald** is entitled to receive, for the remainder of his life, annual payments equal to the average of the sum of his Base Salary plus bonuses in the three highest years, multiplied by 3%, multiplied by his years of service. **Donald** has also been awarded 200,000 "units" under the Long Term Incentive Plan. In the event of a Change of Control, as defined in the Incentive Plan, **Donald** will have the right to cash payments for his units, which **Grimes** alleges could total $60,000,000 at the stock price in effect at the time the complaint was filed.

As required by Court of Chancery Rule 23.1, **Grimes** alleges in his complaint that he wrote to the Board on September 23, 1993 and demanded that the Board abrogate the Agreements. The demand letter states, in part:

> Paragraph 2(c) of the Employment Agreement dated as of January 1, 1990, between the Company and Mr. **Donald** purports to vest in Mr. **Donald** "the general management of the affairs of the Company." Under Paragraph 1(f)(vii) of the Employment Agreement, Mr. **Donald** is deemed to have been constructively terminated without cause, if there is "unreasonable interference, in the good-faith judgment of [Mr. **Donald**], by the Board or a substantial stockholder of the Company, in [Mr. **Donald's**] carrying out his duties and responsibilities under the Agreement."
>
> Paragraph 1(f)(vii), therefore, purports to put Mr. **Donald** in a position unilaterally to declare a "constructive termination without cause" whenever he declares that the Board has "unreasonably interfered" with his general management of the affairs of the Company. Other provisions, including, without limitation, Paragraphs 11(d) and 27 of the Employment Agreement and Paragraph 4(b) of the DSC Communications Corporation Executive Income Continuation Plan dated as of January 1, 1990, between the Company and Mr. **Donald**, would impose drastic costs and burdens on the Company in the event of such a "constructive termination without cause."
>
> ***1212** The effect of the cited provision is to delegate the duties and responsibilities of the Board of Directors to Mr. **Donald**. This delegation is contrary to law and inconsistent with the certificate of incorporation and bylaws of the Company.

* * * * * *

> The cited provisions of the Employment Agreement are therefore void as a matter of law. Although they are void, they should be abrogated so as to leave no cloud upon the lawful conduct of the Company's affairs. And it should go without saying that the Board must refrain from conducting the business of the Company as if they were valid.

* * * * * *

> Accordingly, I hereby demand that the Board of Directors take immediate steps to abrogate Paragraphs 1(f)(vii) and 2(c) of the Employment Agreement dated as of January 1, 1990, between the Company and James L. **Donald**, and the 1990 Long–Term Incentive Compensation Plan insofar as it applies to Mr. **Donald**.

The Board refused the demand in a letter dated November 8, 1993, which states in part:

> The Compensation Committee of our Board of Directors, as well as the entire Board, have seriously considered the issues set forth in your letter of September 29. To assist in the review, the Board obtained reports analyzing the relevant issues from the Company's outside benefits consultant, Hirschfeld, Stern, Moyer & Ross, Inc. and from the Company's outside legal counsel, Jones, Day, Reavis & Pogue. The Compensation Committee and the full Board of Directors believe that a thorough analysis of the applicable provisions of Delaware law necessarily leads to a conclusion that Mr. **Donald's** duties as described in the Employment Agreement do not constitute an impermissible delegation of the duties of the Board of Directors.

* * * * * *

Accordingly, the provisions relating to the Board's actions set forth in Sections 11(d) and 1(f)(vii) of the Employment Agreement simply relate to the consequences of the Board's unreasonable interference with Mr. **Donald's** properly delegated duties. These provisions do not limit the Board's right to guide the Company through the formulation of policy or its right to take any other action it desires to take. They simply represent the agreement between the Company and Mr. **Donald** regarding the circumstances that will create a constructive termination of his employment and the consequences of such an event.

Based on the foregoing, the Board has concluded that the description of Mr. **Donald's** duties in the Employment Agreement do not constitute an impermissible delegation of the duties of the Board of Directors. Consequently, the Board declines to take any action to abrogate any provision of the Employment Agreement or the 1990 Long–Term Incentive Compensation Plan as you have requested.

II. Grimes Has Not Stated a Claim for Abdication of Directorial Duty.

Despite the fact that **Grimes** demanded that the Board abrogate the Agreements and his demand was refused, the Court of Chancery declined to review the Board's decision to refuse the demand under the business judgment rule, stating:

> Whether these contracts do violate Section 141 is a question of law directly concerning the legal character of the contract and its effect upon the directors. The question whether these contracts are valid or not does not fall into the realm of business judgment; it cannot be definitively determined by the informed, good faith judgment of the board. It must be determined by the court.

Grimes, 20 Del.J.Corp.L. at 771 (citing *Blasius Indus., Inc. v. Atlas Corp.,* Del.Ch., 564 A.2d 651, 663 (1988), which involved a direct action against the board of directors). We agree that the Court of Chancery appropriately analyzed the abdication claim as a direct—as distinct from a derivative—claim.

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Courts have long recognized that the same set of facts can give rise both to a direct claim and a derivative claim. ***1213** *Bennett v. Breuil Petroleum Corp.,* Del.Ch., 99 A.2d 236, 241 (1953); *Borak v. J.I. Case Co.,* 7th Cir., 317 F.2d 838, 844–45 (1963), *aff'd,* 377 U.S. 426, 84 S.Ct. 1555, 12 L.Ed.2d 423 (1964). The due care, waste and excessive compensation claims asserted here are derivative and will be considered as such. *Kramer v. Western Pacific Indus., Inc.,* Del.Supr., 546 A.2d 348, 353 (1988). The abdication claim, however, is a direct claim. In order to reach this conclusion, we believe a further exploration of the distinction between direct and derivative claims is appropriate.

A. Distinction Between Direct and Derivative Claims, Generally

[1] As the Court of Chancery has noted: "Although the tests have been articulated many times, it is often difficult to distinguish between a derivative and an individual action." *In re Rexene Corp. Shareholders Litig.,* Del.Ch., 17 Del.J.Corp.L. 342, 348, 1991 WL 77529 (1991); *see also Abelow v. Symonds,* Del.Ch., 156 A.2d 416, 420 (1959) ("line of distinction ... is often a narrow one ..."). The distinction depends upon " 'the nature of the wrong alleged' and the relief, if any, which could result if plaintiff were to prevail." *Kramer v. Western Pacific,* 546 A.2d at 352 (quoting *Elster v. American Airlines, Inc.,* Del.Ch., 100 A.2d 219, 221–223 (1953)). To pursue a direct action, the stockholder-plaintiff "must allege more than an injury resulting from a wrong to the corporation." *Id.* at 351. The plaintiff must state a claim for " 'an injury which is separate and distinct from that suffered by other shareholders,' ... or a wrong involving a contractual right of a shareholder ... which exists independently of any right of the corporation." *Moran v. Household Int'l, Inc.,* Del.Ch., 490 A.2d 1059, 1070, *aff'd,* Del.Supr., 500 A.2d 1346 (1985) (quoting 12B FLETCHER CYCLOPEDIA CORPS., § 5291 (Perm.Ed.1984)).

The American Law Institute ("ALI") *Principles of Corporate Governance: Analysis and Recommendations* (1992) ("*Principles* ") is helpful in this instance. Section 7.01 of the *Principles* undertakes to state the common law with respect to the distinction between direct and derivative actions. *Id.* § 7.01, cmt. a. The Comment also discusses a situation relevant to the case *sub judice:*

> In some instances, actions that essentially involve the structural relationship of the shareholder to the corporation ... may also give rise to a derivative action when the corporation suffers or is threatened with a loss. One example would be a case in which a corporate official knowingly acts in a manner that the certificate of incorporation [or the Delaware General Corporation Law] denied the official authority to do, thereby violating both specific restraints imposed by the shareholders [or the GCL] and the official's duty of care.

Id., cmt. c. The Comment further notes that, "courts have been more prepared to permit the plaintiff to characterize the action as direct when the plaintiff is seeking only injunctive or prospective relief." *Id.,* cmt. d.

With respect to the abdication claim, Grimes seeks only a declaration of the invalidity of the Agreements. Monetary recovery will not accrue to the corporation as a result. Chancellor Seitz illustrated this distinction in *Bennett.* The Court of Chancery there allowed the plaintiff-stockholder to proceed individually on his claim that stock was issued for an improper purpose and entrenchment; he proceeded derivatively on his claim that the stock was issued for an insufficient price. 99 A.2d at 241.

B. Applicable Pleading Standards

[2] [3] [4] [5] Since the abdication claim is direct, not derivative, a motion to dismiss such a claim pursuant to Chancery Rule 12(b)(6) implicates the pleading standard of Chancery Rule 8(a). *Solomon v. Pathe Communications Corp.,* Del.Supr., 672 A.2d 35, 39 (1996). Neither the pleading standard of Chancery Rule 9(b) ("circumstances constituting fraud or mistake shall be stated with particularity") nor that of Chancery Rule 23.1 which requires, with respect to derivative claims, that a plaintiff plead "with particularity the efforts, if any ... to obtain the action the plaintiff desires ... and the reasons for the ... failure to obtain the action or for not making the effort," is implicated. Chancery Rule 8(a), which is implicated here, requires only "a short and plain statement of the claim." In considering a motion to dismiss for failure to state a direct claim, the Court of Chancery assumes the truth of well-pleaded ***1214** allegations, giving to the plaintiff "the benefit of all reasonable inferences that can be drawn from ... [the] pleading." *In re USA Cafes, L.P. Litig.,* Del.Ch., 600 A.2d 43, 47 (1991); *see also In re Santa Fe Pacific Corp. Shareholder Litig.,* Del.Supr., 669 A.2d 59, 65–66 (1995). Conclusory statements without supporting factual averments will not be accepted as true for purposes of a motion to dismiss. *In re Tri–Star Pictures, Inc. Litig.,* Del.Supr., 634 A.2d 319, 326 (1995). We review *de novo* the decision by the Court of Chancery on a motion to dismiss a direct claim, applying the same legal standard. *Solomon v. Pathe Communications Corp.,* 672 A.2d at 39.

C. Analysis of Grimes' Abdication Claim

[6] In the case before us, the abdication claim fails as a matter of law. **Grimes** claims that the potentially severe financial penalties which the Company would incur in the event that the Board attempts to interfere in **Donald's** management of the Company will inhibit and deter the Board from exercising its duties under Section 141(a).[1] The Court of Chancery assumed that, if a contract could have the practical effect of preventing a board from exercising its duties, it would amount to a *de facto* abdication of directorial authority.[2] The Chancellor concluded, however, that **Grimes** has not set forth well-pleaded allegations which would establish such a situation. We agree.

Putting aside the payments which would result from a change of control, **Grimes** has pleaded, at most, that **Donald** would be entitled to $20 million in the event of a Constructive Termination. The Chancellor found, in light of the financial size of DSC reflected in the exhibits to the complaint, that this amount would not constitute a *de facto* abdication. **Grimes** contends, however, that the payments could amount to a *de facto* abdication in possible future circumstances. Such a set of facts has not been pleaded, is not before this Court, is based on speculation, and is not ripe for adjudication.[3]

Directors may not delegate duties which lie "at the heart of the management of the corporation." *Chapin v. Benwood,* Del.Ch., 402 A.2d 1205, 1210 (1979), *aff'd sub nom. Harrison v. Chapin,* Del.Supr., 415 A.2d 1068 (1980). A court "cannot give legal sanction to agreements which have the effect of removing from directors in a very substantial way their duty to use their own best judgment on management matters." *Abercrombie v. Davies,* Del.Ch., 123 A.2d 893, 899 (1956), *rev'd on other grounds,* Del.Supr., 130 A.2d 338 (1957). Distinguishing these cases, however, the Court of Chancery stated: "[U]nlike the agreements considered in *Abercrombie* and *Chapin,* the **Donald** Agreements do not formally preclude the DSC board from exercising its statutory powers and fulfilling its fiduciary duty." ***Grimes,*** 20 Del.J.Corp.L. at 774–775. *Compare Rosenblatt v. Getty Oil Co.,* Del.Supr., 493 A.2d 929, 943–44 (1985) (delegation to independent appraiser of responsibility to value oil and gas reserves as part of a merger agreement was proper exercise of business judgment).

With certain exceptions, "an informed decision to delegate a task is as much an exercise of business judgment as any other." *Rosenblatt,* 493 A.2d at 943. Likewise, business decisions are not an abdication of directorial authority merely because they limit a board's freedom of future action. A board which has decided to manufacture bricks has less freedom to decide to make bottles. In a

world of scarcity, a decision to do one thing will commit ***1215** a board to a certain course of action and make it costly and difficult (indeed, sometimes impossible) to change course and do another. This is an inevitable fact of life and is not an abdication of directorial duty.

If the market for senior management, in the business judgment of a board, demands significant severance packages, boards will inevitably limit their future range of action by entering into employment agreements. Large severance payments will deter boards, to some extent, from dismissing senior officers. If an independent and informed board, acting in good faith, determines that the services of a particular individual warrant large amounts of money, whether in the form of current salary or severance provisions, the board has made a business judgment. That judgment normally will receive the protection of the business judgment rule unless the facts show that such amounts, compared with the services to be received in exchange, constitute waste or could not otherwise be the product of a valid exercise of business judgment. *See, e.g., Saxe v. Brady,* Del.Ch., 184 A.2d 602, 610 (1962).

The Board of DSC retains the ultimate freedom to direct the strategy and affairs of the Company. If Donald disagrees with the Board, the Company may or may not (depending on the circumstances) be required to pay him a substantial sum of money in order to pursue its chosen course of action. So far, we have only a rather unusual contract, but not a case of abdication. [4] The Chancellor correctly dismissed the abdication claim.

III. Grimes' Demand on The Board With Respect to The Derivative Claim Conceded That Demand Was Required.

The complaint alleges that Grimes made a pre-suit demand on the Board in the September 29, 1993, letter quoted above. In summary, the letter described the relevant provisions of the Donald Agreements and demanded that the Board "take immediate steps to abrogate" the cited sections of the Agreements. The Court of Chancery held that, by "making demand upon the board, plaintiff has in effect conceded that the board was in a position to consider and act upon his demand." ***Grimes****,* 20 Del.J.Corp.L. at 772 (citing *Spiegel v. Buntrock,* Del.Supr., 571 A.2d 767, 775 (1990)). Contending that demand was excused, Grimes later filed suit alleging waste, excessive compensation and due care claims arising out of the Agreements. But the Chancellor held that Grimes waived his right to argue that demand was excused with respect to these claims because he had already made demand that the agreements be abrogated as unlawful. *Id.* We agree.

A. The Demand Requirement in Perspective

Because the prolix (43 page) complaint tends to confuse the issues in this case, it is appropriate to restate, as a matter of background, the Delaware jurisprudence relating to stockholder derivative litigation.

If a claim belongs to the corporation, it is the corporation, acting through its board of directors, which must make the decision whether or not to assert the claim. "[T]he derivative action impinges on the managerial freedom of directors." *Pogostin v. Rice,* Del.Supr., 480 A.2d 619, 624 (1984). "[T]he demand requirement is a recognition of the fundamental precept that directors manage the business and affairs of the corporation." *Aronson v. Lewis,* Del.Supr., 473 A.2d 805, 812 (1984).

***1216** **[7]** A stockholder filing a derivative suit must allege either that the board rejected his pre-suit demand that the board assert the corporation's claim or allege with particularity why the stockholder was justified in not having made the effort to obtain board action. This is a "basic principle of corporate governance" and is a matter of substantive law embodied in the procedural requirements of Chancery Rule 23.1. [5]

[8] **[9]** One ground for alleging with particularity that demand would be futile is that a "reasonable doubt" exists that the board is capable of making an independent decision to assert the claim if demand were made. [6] The basis for claiming excusal would normally be that: (1) a majority

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of the board has a material financial or familial interest;[7] (2) a majority of the board is incapable of acting independently for some other reason such as domination or control;[8] or (3) the underlying transaction is not the product of a valid exercise of business judgment.[9] If the stockholder cannot plead such assertions consistent with Chancery Rule 11,[10] after using the "tools at hand"[11] to obtain the necessary information before filing a derivative action, then the stockholder must make a pre-suit demand on the board.

The demand requirement serves a salutary purpose. First, by requiring exhaustion of intracorporate remedies, the demand requirement invokes a species of alternative dispute resolution procedure which might avoid litigation altogether.[12] Second, if litigation is beneficial, the corporation can control the proceedings. Third, if demand is excused or wrongfully refused, the stockholder will normally control the proceedings.[13]

***1217** The jurisprudence of *Aronson* and its progeny is designed to create a balanced environment which will: (1) on the one hand, deter costly, baseless suits by creating a screening mechanism to eliminate claims where there is only a suspicion expressed solely in conclusory terms;[14] and (2) on the other hand, permit suit by a stockholder who is able to articulate particularized facts showing that there is a reasonable doubt either that (a) a majority of the board is independent for purposes of responding to the demand, or (b) the underlying transaction is protected by the business judgment rule.[15]

[10] *Aronson* introduced the term "reasonable doubt" into corporate derivative jurisprudence. Some courts and commentators have questioned why a concept normally present in criminal prosecution would find its way into derivative litigation.[16] Yet the term is apt and achieves the proper balance. Reasonable doubt can be said to mean that there is a reason to doubt.[17] This concept is sufficiently flexible and workable to provide the stockholder with "the keys to the courthouse"[18] in an appropriate case where the claim is not based on mere suspicions or stated solely in conclusory terms.

B. Wrongful Refusal Distinguished from Excusal

[11] **[12]** **[13]** Demand has been excused in many cases in Delaware under the *Aronson* test.[19] The law regarding wrongful refusal is ***1218** not as well developed, however.[20] Although Delaware law does not require demand in every case[21] because Delaware does have the mechanism of demand excusal, it is important that the demand process be meaningful. Therefore, a stockholder who makes a demand is entitled to know promptly what action the board has taken in response to the demand. A stockholder who makes a serious demand and receives only a peremptory refusal has the right to use the "tools at hand" to obtain the relevant corporate records, such as reports or minutes, reflecting the corporate action and related information in order to determine whether or not there is a basis to assert that demand was wrongfully refused.[22] In no event may a corporation assume a position of neutrality and take no position in response to the demand. *Kaplan v. Peat, Marwick, Mitchell & Co.,* Del.Supr., 540 A.2d 726 (1988).

[14] **[15]** If a demand is made, the stockholder has spent one—but only one—"arrow" in the "quiver." The spent "arrow" is the ***1219** right to claim that demand is excused.[23] The stockholder does not, by making demand, waive the right to claim that demand has been wrongfully refused.[24]

Simply because the composition of the board provides no basis *ex ante* for the stockholder to claim with particularity and consistently with Rule 11 that it is reasonable to doubt that a majority of the board is either interested or not independent, it does not necessarily follow *ex post* that the board in fact **acted** independently, disinterestedly or with due care in response to the demand. A board or a committee of the board may **appear** to be independent, but may not always **act** independently.[25] If a demand is made and rejected,

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the board rejecting the demand is entitled to the presumption of the business judgment rule unless the stockholder can allege facts with particularity creating a reasonable doubt that the board is entitled to the benefit of the presumption.[26] If there is reason to doubt[27] that the board acted independently or with due care in responding to the demand, the stockholder may have the basis *ex post* to claim wrongful refusal. The stockholder then has the right to bring the underlying action with the same standing which the stockholder would have had, *ex ante,* if demand had been excused as futile. *See Stepak v. Addison,* 11th Cir., 20 F.3d 398 (1994).

The same concerns are expressed in the *Restatement (Second) of Judgments,* which asserts that "fairness to the defendant, and sound judicial administration, require that at some point litigation over the particular controversy come to an end." RESTATEMENT (SECOND) OF JUDGMENTS § 19, cmt. a. (1980). Since the making of a pre-suit demand concedes ***1220** that demand is required, the concession should apply "to all or any part of the transaction, or series of connected transactions, out of which the action [demand] arose." *Id.* § 24; *see Foltz v. Pullman, Inc.,* Del.Super., 319 A.2d 38, 40 (1974).

In *Spiegel,* this Court held that "[a] shareholder who makes a demand can no longer argue that demand is excused." 571 A.2d at 775. Permitting a stockholder to demand action involving only one theory or remedy and to argue later that demand is excused as to other legal theories or remedies arising out of the same set of circumstances as set forth in the demand letter would create an undue risk of harassment.

In this case, the Board of DSC considered and rejected the demand. After investing the time and resources to consider and decide whether or not to take action in response to the demand, the Board is entitled to have its decision analyzed under the business judgment rule unless the presumption of that rule can be rebutted. *Spiegel,* 571 A.2d at 776. **Grimes** cannot avoid this result by holding back or bifurcating legal theories based on precisely the same set of facts alleged in the demand.

C. Application to This Case

[16] In the case before the Court, plaintiff made a pre-suit demand.[28] Later, however, plaintiff contended that demand was excused. Under the doctrine articulated by this Court in *Spiegel v. Buntrock,*[29] plaintiff, by making a demand, waived his right to contest the independence of the board. As the Court of Chancery properly held, plaintiff may not bifurcate his theories relating to the same claim. Thus, demand having been made as to the propriety of the Agreements, it cannot be excused as to the claim that the Agreements constituted waste, excessive compensation or was the product of a lack of due care.

The Court of Chancery implicitly applied a test analogous to *res judicata* to determine whether **Grimes**' demand letter conceded that demand was required for all legal theories arising out of the set of facts described in the demand letter. We believe this to be a correct approach. The alternative claims raised in the complaint fit squarely within the same transactional rubric as the demand since all of the claims, however denominated, arise out of the Agreements. As the Court of Chancery stated: "There is little to recommend a process in which a shareholder seeks board consideration of only some aspects of a transaction or puts forward only selected theories for board consideration, while reserving other theories for judicial consideration. Such a process would be neither efficient nor fair." ***Grimes**,* 20 Del.J.Corp.L. at 772.

[17] Since **Grimes** made a pre-suit demand with respect to all claims arising out of the Agreements, he was required by Chancery Rule 23.1 to plead with particularity why the Board's refusal to act on the derivative claims was wrongful. *Levine v. Smith,* 591 A.2d at 211. The complaint recites the Board's rejection of **Grimes**' demand and proceeds to assert why **Grimes** disagrees with the Board's conclusion. The complaint generally asserts that the refusal could not have been the result of an adequate, good faith investigation since the Board decided not to act on the demand. Such conclusory, *ipse dixit,* assertions are inconsistent with the requirements

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of Chancery Rule 23.1. *See Levine,* 591 A.2d at 214. The complaint fails to include particularized allegations which would raise a reasonable doubt that the Board's decision to reject the demand was the product of a valid business judgment. [30]

IV. Conclusion

Accordingly, the judgment of the Court of Chancery is **AFFIRMED.**

All Citations

673 A.2d 1207, 64 USLW 2691

Footnotes

1 Section 141(a) provides that: "The business and affairs of every corporation ... shall be managed by or under the direction of a board of directors...." 8 *Del.C.* § 141(a).

2 The cases cited by **Grimes** involve *formal* abdication by a board of directors. *See Chapin v. Benwood Foundation, Inc.,* Del.Ch., 402 A.2d 1205 (1979) (trustees agreed to appoint particular person to future vacancy on board); *Abercrombie v. Davies,* Del.Ch., 123 A.2d 893 (1956), *rev'd on other grounds,* Del.Supr., 130 A.2d 338 (1957) (directors agreed to vote unanimously or submit to outside arbitrator).

3 The Chancellor perceptively notes that "[a]n even more difficult case would be presented where the terms of a CEO's employment contract came to have the practical effect of precluding the board from exercising its statutory powers and satisfying its fiduciary duty, but that effect was not reasonably foreseeable at the time the contract rights were negotiated at arm's-length." ***Grimes,*** 20 Del.J.Corp.L. at 775 n. 8.

4 The unfortunate choice of language in the Employment Agreement should not obscure the fact that, in many cases, large severance payments do not necessarily preclude a formerly passive board from asserting its power over a CEO. The Court of Chancery, in dismissing the claim, nonetheless disparaged as "foolish" and "ill-conceived" the language of the agreement introducing the concept of the Board committing "unreasonable interference" in the discharge of **Donald's** duties, "in the good faith judgment of the Executive...." 20 Del.J.Corp.L. at 777. We agree that, on the surface, this unfortunate choice of words is "badly flawed" in terms of traditional concepts of corporate governance. *Id.* When the Employment Agreement is read as a whole, however, the initial perception of unlawful delegation gives way to the reality that the Agreement is not—on its face—a wrongful delegation. This poor choice of language in the Agreements is not actionable *per se.* What actually may happen in the future may or may not ever become a litigable issue that is ripe for adjudication.

5 *Kamen v. Kemper Fin. Svcs., Inc.,* 500 U.S. 90, 101, 111 S.Ct. 1711, 1719, 114 L.Ed.2d 152 (1991); *see also* Fed.R.Civ.P. 23.1.

6 *Aronson,* 473 A.2d at 814.

7 *Id.* at 815.

8 *Rales v. Blasband,* Del.Supr., 634 A.2d 927, 936 (1993). Demand is not excused simply because plaintiff has chosen to sue all directors. *Id.* Likewise, a plaintiff cannot necessarily disqualify all directors simply by attacking a transaction in which all participated. *Pogostin v. Rice,* 480 A.2d at 627. To hold otherwise would permit plaintiffs to subvert the particularity requirements of Rule 23.1 simply by designating all the directors as targets.

9 *Aronson,* 473 A.2d at 814.

10 Rule 11 mandates that by signing a pleading, the attorney certifies "that to the best of the person's knowledge, information and belief, formed after an inquiry reasonable under the circumstances ... the allegations and other factual contentions have evidentiary support, or if specifically so identified, are likely to have evidentiary support after a reasonable opportunity for further investigation or discovery; ..." Ct.Ch.R. 11(b)(3).

11 In *Rales* we undertook to describe some of those "tools at hand":

> Although derivative plaintiffs may believe it is difficult to meet the particularization requirement of *Aronson* because they are not entitled to discovery to assist their compliance with Rule 23.1, *see Levine,* 591 A.2d at 208–10, they have many avenues available to obtain information bearing on the subject of their claims. For example, there is a variety of public sources from which the details of a corporate act may be discovered, including the media and governmental agencies such as the Securities and Exchange

> Commission. In addition, a stockholder who has met the procedural requirements and has shown a specific proper purpose may use the summary procedure embodied in 8 *Del.C.* § 220 to investigate the possibility of corporate wrongdoing. *Compaq Computer Corp. v. Horton,* Del.Supr., 631 A.2d 1 (1993).... Surprisingly, little use has been made of section 220 as an information-gathering tool in the derivative context. Perhaps the problem arises in some cases out of an unseemly race to the court house, chiefly generated by the "first to file" custom seemingly permitting the winner of the race to be named lead counsel. The result has been a plethora of superficial complaints that could not be sustained. Nothing requires the Court of Chancery, or any other court having appropriate jurisdiction, to countenance this process by penalizing diligent counsel who has employed these methods, including section 220, in a deliberate and thorough manner in preparing a complaint that meets the demand excused test of *Aronson.*

634 A.2d at 934–935 n. 10.

12 *Aronson,* 473 A.2d at 811–812; *Cramer v. General Tel. & Elecs. Corp.,* 3d Cir., 582 F.2d 259, 275 (1978), *cert. denied,* 439 U.S. 1129, 99 S.Ct. 1048, 59 L.Ed.2d 90 (1979).

13 This Court has held that in demand-excused cases the board of directors may sometimes reassert its authority over a derivative claim in certain instances through the device of the Special Litigation Committee ("SLC"). *Zapata Corp. v. Maldonado,* Del.Supr., 430 A.2d 779 (1981). The use of a committee of the board formed to respond to a demand or to advise the board on its duty in responding to a demand is not the same as the SLC process contemplated by *Zapata,* however. It is important that these discrete and quite different processes not be confused.

14 Block, Radin & Maimone, *Derivative Litigation: Current Law Versus The American Law Institute,* 48 Bus.Law. 1443, 1454 (1993); Dooley & Veasey, *The Role of the Board in Derivative Litigation,* 44 Bus.Law. 503, 539 (1989). Such a concern is not of recent vintage. *See* Note, *Extortionate Corporate Litigation: The Strike Suit,* 34 Colum.L.Rev. 1308 (1934). While the Delaware approach differs from that developed in Part VII of the American Law Institute's Principles of Corporate Governance, many of the goals are the same: "The end result should be that the board's or committee's determinations serve as a vehicle by which an early screening of the action's probable merit and its likely impact upon the corporation is achieved." PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS AND RECOMMENDATIONS, Part VII, Ch. 1, Introductory Notes, at 9 (1992); *see also* MODEL BUSINESS CORP. ACT § 7.42 (1991).

15 Such a test implicates a determination by the Court of Chancery which involves "essentially a discretionary ruling on a predominately factual issue." *Grobow v. Perot,* Del.Supr., 539 A.2d 180, 186 (1988). Judging whether demand is excused "is inescapably a question of judgment...." *Harris v. Carter,* Del.Ch., 582 A.2d 222, 229 (1990). The exercise of discretion by experienced and capable judges is a satisfactory screening mechanism, in our view.

16 *See* Coffee, *New Myths and Old Realities: The American Law Institute Faces the Derivative Action,* 48 Bus.Law. 1407, 1413 (1993); *Starrels v. First Nat'l Bank of Chicago,* 7th Cir., 870 F.2d 1168, 1174 (1989) (Easterbrook, J., concurring). Some have contended that the Delaware jurisprudence has erected unfortunate barriers to derivative litigation. *See* Coffee, 48 Bus.Law. at 1411. *See also* Seligman, *The New Corporate Law,* 59 Brook.L.Rev. 1, 27 (1993); Gevurtz, *Who Represents the Corporation? In Search of a Better Method for Determining the Corporate Interest in Derivative Suits,* 46 U.Pitt.L.Rev. 265, 285 (1985). We disagree. *See Rales,* 634 A.2d at 934; *see also* Moore, *Shareholder Rights Still Alive and Well in Delaware: The Derivative Suit: A Death Greatly Exaggerated,* 38 St. Louis L.J. 947 (1994). Professor Coffee admits the possibility that: "Arguably, the open-textured latitude inherent in *Aronson* 's test may be its saving grace." 48 Bus.Law. at 1413.

17 Stated obversely, the concept of reasonable doubt is akin to the concept that the stockholder has a "reasonable belief" that the board lacks independence or that the transaction was not protected by the business judgment rule. The concept of reasonable belief is an objective test and is found in various corporate contexts. *See* 8 *Del. C.* § 145(a) & (b). *Cf.* THE MODEL BUSINESS CORP. ACT § 8.30. *See also* ALI, PRINCIPLES OF CORP. GOVERNANCE § 4.01(a). *Compare* Veasey & Manning, *Codified Standard—Safe Harbor or Unchartered Reef,* 35 Bus.Law. 919 (1980), *with* Arsht & Hinsey, *Codified Standard—Safe Harbor but Chartered Channel,* 35 Bus.Law. No. 4, ix (1980).

18 *See* Dooley & Veasey, 44 Bus.Law. at 504.

19 Some of the relatively recent cases include the following: *Heineman v. Datapoint Corp.,* Del.Supr., 611 A.2d 950 (1992); *Harris v. Carter,* Del.Ch., 582 A.2d 222 (1990); *Friedman v. Beningson,* Del.Ch., C.A. No.

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12232, 1995 WL 716762, Allen C. (Dec. 4, 1995); *Good v. Texaco, Inc.,* Del.Ch., 9 Del.J.Corp.L. 461, 1984 WL 8220 (1984); *Kells–Murphy v. McNiff,* C.A. No. 11009, 1991 WL 137143, Jacobs, V.C. (July 12, 1991); *Seibert v. Harper & Row Publishers, Inc.,* Del.Ch., 10 Del.J.Corp.L. 645, 1984 WL 21874 (1984); *Edelman v. Phillips Petroleum Co.,* Del.Ch., 10 Del.J.Corp.L. 835, 1985 WL 11534 (1985); *Moran v. Household Int'l, Inc.,* Del.Ch., 490 A.2d 1059, *aff'd on other grounds,* Del.Supr., 500 A.2d 1346 (1985); *L.A. Partners, L.P. v. Allegis Corp.,* Del.Ch., [1987–1988 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 93,505 at 97,247, 1987 WL 14531 (1987); *In re Chrysler Corp. Shareholders Litig.,* Del.Ch., [1992 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 93,505, 1992 WL 181024, (1992); *Chrysogelos v. London,* Del.Ch., C.A. No. 11910, 1992 WL 58516, Jacobs, V.C. (Mar. 25, 1992); *Abajian v. Kennedy,* Del.Ch., 18 Del.J.Corp.L. 179, 1992 WL 8794 (1992); *Strougo v. Carroll,* Del.Ch., 17 Del.J.Corp.L. 352, 1991 WL 9978 (1991); *In re NVF Co. Litig.,* Del.Ch., 16 Del.J.Corp.L. 361, 1989 WL 146237 (1989); *Manchester v. Narragansett Capital, Inc.,* Del.Ch., C.A. No. 10822, 1989 WL 125190 (Oct. 18, 1989); *Siegman v. Tri–Star Pictures, Inc.,* Del.Ch., 15 Del.J.Corp.L. 218, 1989 WL 48746 (1989), *aff'd and rev'd on other grounds sub nom., In re Tri–Star Pictures, Inc. Litig.,* Del.Supr., 634 A.2d 319 (1993); *Sealy Mattress Co. of N.J., Inc. v. Sealy, Inc.,* Del.Ch., Fed.Sec.L.Rep. (CCH) ¶ 93,331, 1987 WL 15254 (July 20, 1987); *Tomczak v. Morton Thiokol, Inc.,* Del.Ch., 12 Del.J.Corp.L. 381, 1986 WL 5481 (1986); *Lewis v. Hett,* Del.Ch., 10 Del.J.Corp.L. 240 (1984) (waste); *Stein v. Orloff,* Del.Ch., 11 Del.J.Corp.L. 312, 1985 WL 11561 (1985) (waste); *Avacus Partners, L.P. v. Brian,* Del.Ch., [1991 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 96,232, 1990 WL 161909 (Oct. 24, 1990); *Andreae v. Andreae,* Del.Ch., 18 Del.J.Corp.L. 197, 1992 WL 43924 (1992); *Rosan v. Chicago Milwaukee Corp.,* Del.Ch., 16 Del.J.Corp.L. 378, 1990 WL 13482 (1990); *Lewis v. Aronson,* Del.Ch., 11 Del.J.Corp.L. 243, 1985 WL 11553 (1985); *Katell v. Morgan Stanley Group, Inc.,* Del.Ch., [1992–1993 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 97,437, 1993 WL 10871 (1993); *Steiner v. Meyerson,* [1995 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 98,857, 1995 WL 441999 (1995); *Kahn v. Tremont Corp.,* Del.Ch., C.A. No. 12339, 1994 WL 162613, Allen, C. (April 21, 1994); *Yaw v. Talley,* Del.Ch., 20 Del.J.Corp.L. 454, 1994 WL 89019 (1994); *Leslie v. Telephonics Office Tech., Inc.,* Del.Ch., 19 Del.J.Corp.L. 1237, 1993 WL 547188 (1993); *Kahn v. Roberts,* Del.Ch., [1993–1994 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 98,201, 1994 WL 70118 (1994); *Emerald Partners v. Berlin,* Del.Ch., 19 Del.J.Corp.L. 1182, 1993 WL 545409 (1993); *Rothenberg v. Santa Fe Pacific Corp.,* Del.Ch., C.A. No. 11749, 1995 WL 523599, Jacobs, V.C. (Sept. 5, 1995).

20 *See, e.g., Levine v. Smith,* Del.Supr., 591 A.2d 194 (1991); *Allison v. General Motors Corp.,* D.Del., 604 F.Supp. 1106 (1985); *Levit v. Shrontz,* Del.Ch., C.A. No. 11273, 1994 WL 30542, Berger, V.C. (Jan. 19, 1994); *Mount Moriah Cemetery v. Moritz,* Del.Ch., Fed.Sec.L.Rep. (CCH) ¶ 95,900, 1991 WL 50149 (April 4, 1991); *Stepak v. Addison,* 11th Cir., 20 F.3d 398 (1994). *See also* Coffee, 48 Bus.Law. 1407.

21 The ALI *Principles* and the American Bar Association's *Model Business Corporation Act* § 7.42(1), both are premised upon the concept of universal demand—that is, a requirement that demand must be made in every case. The *Principles* and the *Model Act* then go in directions which are different from Delaware law and different from each other in determining the manner in which derivative litigation is to be conducted or terminated after demand has been made. In reversing the decision of the United States Court of Appeals for the Seventh Circuit, which had adopted the universal demand rule in a derivative suit under the Investment Company Act of 1940, the Supreme Court of the United States held that state law applied and analyzed the implications of the universal demand rule compared with the traditional rule exemplified by Delaware law. *Kamen v. Kemper Fin. Svcs., Inc.,* 500 U.S. 90, 101–08, 111 S.Ct. 1711, 1719–23, 114 L.Ed.2d 152 (1991).

22 *See* note 11, *supra.* Normally, however, the discovery procedures of Chancery Rules 26–37 are not available to a stockholder to uncover the basis for a claim not yet stated with particularity. *Levine,* 591 A.2d at 209. For a view to the contrary, see Note, *Discovery in Federal Demand–Refused Litigation,* 105 Harv.L.Rev. 1025 (1992).

23 *Spiegel,* 571 A.2d 767; *accord* Demott, SHAREHOLDER DERIVATIVE ACTIONS LAW AND PRACTICE § 5:11.

24 *Levine,* 591 A.2d at 210; *Allison,* 604 F.Supp. at 1121.

25 *See Kahn v. Lynch Communication Sys.,* Del.Supr., 638 A.2d 1110, 1120–21 (1994) ("*Kahn I* ") ("independent committee" of the board did not act independently when it succumbed to threat of controlling stockholder, thus invoking entire fairness analysis rather than business judgment rule).

26 *Levine,* 591 A.2d at 212; *Allison,* 604 F.Supp. at 1121. For an analysis, generally, of the nature of the business judgment rule presumption and the manner in which it may be overcome, *see Cinerama, Inc. v.*

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Technicolor, Inc., Del.Supr., 663 A.2d 1156, 1162 (1995); 1 Balotti & Finkelstein, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 4.6 at 4–43 to 4–67 (1996 Supp.).

27 This may be clear on the face of the refusal or may be developed through the tools at hand. *See* note 11 *supra. See also Thorpe v. CERBCO, Inc.,* Del.Ch., 611 A.2d 5, 11 (1991).

28 Plaintiff also used the 8 *Del.C.* § 220 procedure.

29 571 A.2d 767.

30 Counsel for defendants conceded at oral argument that there is nothing to bar plaintiff from making another such demand. Whether or not there may be a basis to assert wrongful refusal of any such future demand is not before us.

End of Document

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1995 WL 54441

UNPUBLISHED OPINION. CHECK COURT RULES BEFORE CITING.
Court of Chancery of
Delaware, New Castle County.

C.L. **GRIMES**, Plaintiff,
v.
James L. **DONALD**, Clement M. Brown, Jr., Frank J. Cummiskey, Raymond J. Dempsey, John Fairclough, James L. Fischer, Robert S. Folsom, James P. Leake, James M. Nolan and Jim A. Watson, Defendants,
and
DSC Communications Corporation, Nominal Defendant.

No. CIV. A. 13358.
|
Submitted Sept. 21, 1994.
|
Decided Jan. 11, 1995.

Attorneys and Law Firms

Clark W. Furlow and Michele C. Gott of Smith, Katzenstein & Furlow, Wilmington; Thaddeus Holt, Point Clear, AL, of counsel, for plaintiff.

Robert K. Payson, and Stephen C. Norman of Potter Anderson & Corroon, Wilmington, Ronald L. Palmer and Samara L. Kline of Baker & Botts, Dallas, TX, of counsel, for James L. **Donald**.

Thomas R. Hunt, Jr. and Lawrence A. Hamermesh of Morris, Nichols, Arsht & Tunnell, Wilmington, Jones, Day, Reavis & Pogue, Dallas, TX, of counsel, for defendants.

MEMORANDUM OPINION

ALLEN, Chancellor.

***1** This suit, brought by a shareholder of DSC Communications Corporation ("DSC"), seeks a judicial declaration of the invalidity of certain compensation agreements between DSC and James L. **Donald**, its CEO and chairman on the ground, *inter alia* that they constitute corporate waste and result in an abdication of board authority and responsibility in violation of Section 141(a) of the Delaware General Corporation Law ("DGCL").

Mr. **Donald's** employment contract is on its face unusual and troubling in that it contains a provision to the effect that should he unilaterally determine in good faith that the company's board of directors has unreasonably interfered with his management of the corporation, then he may declare his employment terminated and, in doing so qualify for what are alleged to be large payments. It is the ill-conceived concept of the board of directors interfering with the CEO's management that has attracted the most attention from plaintiff.

Under Section 141 of the Delaware General Corporation Law, as under analogous provisions of the incorporation statutes of other states, it is the elected board of directors that bears the ultimate duty to manage or supervise the management of the business and affairs of the corporation. Ordinarily, this responsibility entails the duty to establish or approve the long-term strategic, financial and organizational goals of the corporation; to approve formal or informal plans for the achievement of these goals; to monitor corporate performance; and to act, when in the good faith, informed judgment of the board it is appropriate to act. While these responsibilities may be satisfied in various ways and with varying degrees of formality, it is essential that the members of the board understand that it is with the board and not with the officers of the corporation that ultimate responsibility lies. It is in the light of this fact that I refer to the contractual concept of board interference with the CEO as ill-conceived.

This suit seeks, first, an adjudication that three contracts between Mr. **Donald** and DSC are inconsistent with Section 141(a) of DGCL and are void as against public policy. It is asserted that these contracts constitute not only a violation of Section 141 but of the fiduciary duties of the corporation's directors. In addition the complaint asserts that DSC's board was inadequately informed when it approved these contracts. Second, the complaint

alleges that these contracts contemplate payments that will constitute corporate waste or will constitute an unenforceable penalty. Lastly, this action seeks a declaration that a proxy statement for the 1994 annual meeting of stockholders was false and misleading with respect to its description of the employment contract rights of Mr. **Donald**. As to this claim plaintiff also seeks an injunction against DSC's performance under the contracts.

Pending is a motion of all defendants to dismiss (1) all claims arising from Mr. **Donald's** various employment agreements for a failure to state a claim upon which relief may be granted; (2) any purported waste claim on the ground of ripeness; and (3) the derivation aspects of the complaint on grounds that plaintiff's pre-suit demand that the board seek rescission of these contracts was denied and that determination is, in the circumstances, conclusive. The allegations directed to DSC's 1994 proxy statement have not been the subject of attention on this motion and are thus not considered by me now.

***2** For the reasons that follow I conclude that plaintiff has no standing presently to litigate any claim arising from the various contracts he attacks except the claim that they constitute an unlawful abdication of director duty and, with respect to that claim, the facts alleged fail to state a claim. Thus, with the exception of the proxy claims, the motion to dismiss the complaint will be granted.

I. Allegations

A. The Parties

DSC is a publicly held telecommunications manufacturer, marketer, and servicer incorporated in the State of Delaware. In addition to **Donald**, DSC's board at the time of the approval of the contracts in issue was composed of Messrs. Brown, Cumminskey, Fischer, Folsom, Leake, Nolan, and Watson, as well as three others who are not defendants in this action. At the time plaintiff's demand for action was rejected, the DSC board comprised all of the same directors except for Leake and Watson who were replaced by Defendants Dempsey and Fairclough. [1]

According to the complaint, in 1990 the Compensation Committee of the DSC board approved the three contracts in contention: an employment agreement (the "Employment Agreement"); the Executive Income Continuation Plan (the "Income Continuation Plan"); and a benefits plan denominated the 1990 Long-Term Incentive Compensation Plan (the "Long-Term Plan") (collectively, the "**Donald** Agreements"). They did this at a July 23, 1990 meeting, and immediately thereafter the Committee recommended the contracts to the full board. The full board heard from an outside compensation consultant and then approved the **Donald** Agreements, though the final version of the **Donald** Agreements were allegedly not arrived at until after this meeting.

B. The Donald Agreements

The three contracts delegate to **Donald** extensive, and allegedly exclusive, managing authority over DSC and provide for his compensation. It is the combination of the comprehensive power delegated, the unilateral power to declare a termination, and the benefits payable in the event of termination that plaintiff claims together constitute an abandonment by the board of its obligation to manage the enterprise. [2]

(a) The *Employment Agreement* was approved on June 23, 1990, but became effective as of January 1, 1990.

The Employment Agreement defines **Donald's** duties, compensation, and scope of authority. It designates **Donald** as chief executive officer of the Company. In his capacity as CEO, **Donald** is "responsible for the general management of the affairs of the [c]ompany," and "in carrying out his duties ... [he] shall report to the [b]oard" of directors. [3]

Under this agreement **Donald's** employment is continued as chief executive officer of the company until either (1) the attainment of age 75 (which will occur in the year 2006) or (2) his termination by (a) death or disability (b) termination by DSC for cause

or (c) his termination without cause. In the event of termination without cause benefits under the contract continue to be payable for an additional period of 6½ years. It is provided that after July 6, 1996 **Donald** may "relinquish the Office of Chief Executive Officer," in which event he will continue as Chairman of the board (or if not elected, as consultant to the company).

***3** The base salary set forth in the agreement is $550,000 for 1990 and $650,000 for 1991. If he relinquishes the office of CEO his salary will be 75% of his base salary.

Under the Employment Agreement, **Donald** may declare that he has been "constructively terminated without cause," in a number of identified circumstances. Among these are events that would be expected to constitute substantial concerns of an officer or employee, such as reduction in base salary or existing benefit program (§ 1(f)(i)); significant diminution of responsibilities (§ 1(f)(iv)); failure of the Company in the event of a merger, consolidate, etc., to obtain an assumption in writing or as a matter of law of the Company's obligations under these agreements (§ 1(f)(vi)). More problematically, under § 1(f)(vii) Mr. **Donald** may declare a constructive termination of his Employment Agreement, without cause, if DSC's board of directors "unreasonabl[y] interfere[s] ... in [**Donald's**] carrying out his duties and responsibilities" under the Employment Agreement.

In the event that **Donald** does in good faith declare himself constructively terminated without cause, or DSC terminates him without cause, **Donald** is entitled to the following consideration:

1. Continued payment of his "Base Salary" at the level in effect immediately prior to termination for the remainder of his "Term of Employment." which, as stated, will be 6½ years unless **Donald** dies or turns 75 first. In 1992, **Donald's** Base Salary exceeded $650,000.

2. Annual incentive awards for the remainder of the Term of Employment equal to the average of the three highest annual bonuses awarded to **Donald** during his last ten years as CEO. In 1992, such award allegedly equalled $300,000.

3. Medical benefits for **Donald** and his wife for life, as well as his children until the age of 23.

4. Continued participation in all employee benefit plans in which **Donald** is participating on the date of termination until the earlier of the expiration of the Term of Employment or the date in which he receives equivalent benefits from a subsequent employer.

5. Other (unidentified) benefits in accordance with DSC's plans and programs.

See Am.Cplt.Ex. 1 § 11(d).

In addition to these benefits, in the event of a constructive termination or an actual termination without cause, **Donald** will also receive monetary benefits under the other two agreements, the Income Continuation Plan and the Long-Term Plan.

(b) Pursuant to the *Income Continuation Plan,* once the Term of Employment under the Employment Agreement ends, **Donald** is entitled to receive annual payments for the remainder of his life in the amount of three percent of the sum of [(1) his base salary at the time of termination, plus (2) the average of the three highest bonuses of his last 10 years of DSC employment], multiplied by his years of service. His "years of service" include the years following a constructive termination but preceding the commencement of the Income Continuation Plan payments.

***4** (c) Under the third contract, *the Long-Term Plan,* **Donald** was awarded 200,000 "units," all of which will have vested by the end of 1995. As disclosed in the Long-Term Plan, which is appended to the amended complaint, a unit is simply an account on the Company's books, which is annually credited, pro-rata with all units, with an amount of money as a form of incentive cash compensation. The cumulative value of the "unit" is simply the value of all past contributions. (It is not clear whether or how amounts held in such accounts appreciate, but that fact is not material to the

issues presented). Units can be liquidated under various circumstances;[4] they carry a "gross-up" right to make the compensation they represent tax free to the employee. The Plan is administered by a board committee. Notably the Long-Term Plan includes no formula by which the Company's annual contribution to the Plan is determined. It is to be determined annually "in accordance with criteria established by the [board] Committee" administering it. *See* Am.Cplt.Ex. 3 at § 7.1.

In the event of a "Change in Control," as defined in the Employment Agreement and the Long-Term Plan, the Plan contemplates enhanced benefits. In that event, it is alleged that **Donald** would be entitled to receive a very large sum.[5]

If a change in control occurs, **Donald** is entitled under the Long-Term Plan to the cash equivalent of the greater of the "Cumulative Unit Value" of his "Units," or *the value of five shares of DSC common stock for each "Unit" held. See* Am.Cplt.Ex. 3 at § 8.3. The complaint does not allege the monetary value of **Donald's** "Cumulative Unit Value". It is alleged that DSC common stock was trading at approximately $60 a share immediately prior to this action being brought. Using this figure, **Donald**, holding 200,000 "Units," would be entitled to sixty million dollars in the event of a change in control as defined in the Employment Agreement and the Long-Term Plan.

The wisdom of these contracts as a business matter is not a question upon which this court is required or qualified to express an opinion.

II. Legal Standard

The legal test applicable to motions to dismiss for failure to state a claim is well settled. In order for such a motion to be granted the movant must show that the plaintiff would not be entitled to relief under any set of facts that could be proven under the allegations made. *Rabkin v. Philip A. Hunt Chemical Corp.,* Del.Supr., 498 A.2d 1099, 1104 (1985). A complaint will not be dismissed "unless it is clearly without merit, either as a matter of law or fact." *Id.* The facts alleged are accepted as true for this purpose. *Rales v. Blasband,* Del.Supr., 634 A.2d 927, 931 (1993); *Grobow v. Perot,* Del.Supr., 539 A.2d 180, 187 n. 6 (1988). Inferences, where fairly disputable on the face of the pleading, will be drawn in the pleader's favor. But it is often said that allegations of fact that are "mere conclusions" will not alone support a claim. *Grobow,* 539 A.2d at 187 n. 6.

III. Plaintiff's Standing To Litigate DSC Claims

***5** The amended complaint alleges that on September 29, 1993 plaintiff wrote to demand that the board rescind the **Donald** Agreements. That demand is appended to the Amended Complaint as Exhibit 4 and provides in part, as follows:

> Paragraph 2(c) of the Employment Agreement dated as of January 1, 1990, between the Company and Mr. **Donald** purports to vest in Mr. **Donald** "the general management of the affairs of the Company." Under Paragraph 1(f)(vii) of the Employment Agreement, Mr. **Donald** is deemed to have been constructively terminated without cause, if there is "unreasonable interference, in the good-faith judgment of [Mr. **Donald**], by the Board or a substantial stockholder of the Company, in [Mr. **Donald's**] carrying out his duties and responsibilities under the Agreement."
>
> Paragraph 1(f)(vii), therefore, purports to put Mr. **Donald** in a position unilaterally to declare a "constructive termination without cause" whenever he declares that the Board has "unreasonably interfered" with his general management of the affairs of the Company. Other provisions, including, without limitation, Paragraphs 11(d) and 27 of the Employment Agreement and Paragraph 4(b) of the DSC Communications Corporation Executive Income Continuation Plan dated as of January 1, 1990, between the Company and Mr. **Donald**, would impose drastic costs and burdens on the Company in the event of such a "constructive termination without cause."
>
> The effect of the cited provision is to delegate the duties and responsibilities of the Board of Directors to Mr. **Donald**. This delegation

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> is contrary to law and inconsistent with the certificate of incorporation and bylaws of the Company.

> The cited provisions of the Employment Agreement are therefore void as a matter of law. Although they are void, they should be abrogated so as to leave no cloud upon the lawful conduct of the Company's affairs. And it should go without saying that the Board must refrain from conducting the business of the Company as if they were valid.

> Accordingly, I hereby demand that the Board of Directors take immediate steps to abrogate Paragraphs 1(f)(vii) and 2(c) of the Employment Agreement dated as of January 1, 1990, between the Company and James L. **Donald**, and the 1990 Long-Term Incentive Compensation Plan insofar as it applies to Mr. **Donald**.

As alleged in the Amended Complaint, on November 8, 1993 DSC's general counsel reported to Mr. **Grimes**, in part as follows:

> The Compensation Committee of our Board of Directors, as well as the entire Board, have seriously considered the issues set forth in your letter of September 29. To assist in the review, the Board obtained reports analyzing the relevant issues from the Company's outside benefits consultant, Hirschfeld, Stern, Moyer & Ross, Inc. and from the Company's outside legal counsel, Jones, Day, Reaves & Pogue. The Compensation Committee and the full Board of Directors believe that a thorough analysis of the applicable provisions of Delaware law necessarily leads to a conclusion that Mr. **Donald's** duties as described in the Employment Agreement do not constitute an impermissible delegation of the duties of the Board of Directors.

> ***6** Accordingly, the provisions relating to the Board's actions set forth in Sections 11(d) and 1(f)(vii) of the Employment Agreement simply relate to the consequences of the Board's unreasonable interference with Mr. **Donald's** properly delegated duties. These provisions do not limit the Board's right to guide the Company through the formulation of policy or its right to take any other action it desires to take. They simply represent the agreement between the Company and Mr. **Donald** regarding the circumstances that will create a constructive termination of his employment and the consequences of such an event.

> Based on the foregoing, the Board has concluded that the description of Mr. **Donald's** duties in the Employment Agreement do not constitute an impermissible delegation of the duties of the Board of Directors. Consequently, the Board declines to take any action to abrogate any provision of the Employment Agreement or the 1990 Long-Term Incentive Compensation Plan as you have requested.

The question raised by the pending motion to dismiss the complaint in this respect is whether Mr. **Grimes** has standing to litigate the claims that he asserts to the effect that the **Donald** Agreements are voidable.

It is elementary that under Delaware law, the directors of a corporation rather than its shareholders manage the business and affairs of the corporation. *Levine v. Smith,* Del.Supr., 591 A.2d 194 (1991); *Aronson v. Lewis,* Del.Supr., 473 A.2d 805, 811 (1984). As a consequence, it is well established, as well, that it is in the first instance the responsibility of corporate management under the supervision of the board to decide whether to bring a law suit on behalf of the corporation. *Zapata Corp. v. Maldonado,* Del.Supr., 430 A.2d 779, 782 (1981). In recognition of the directors' managerial authority to make decisions concerning the benefits and detriments of bringing suit, a shareholder who believes that a corporate right of action exists will ordinarily be required to make a demand upon the board of directors to do so. Only if he or she makes such a demand and the board

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wrongfully refuses to institute suit, or if the board is so implicated in the wrong *that it cannot make (or there is reasonable doubt that it can make) a valid business judgment on the question whether to institute suit,* is the shareholder authorized to cause the corporation's claims to be adjudicated. *See Haber v. Bell,* Del.Ch., 465 A.2d 353, 357 (1983). Generally the pre-suit demand requirement of Rule 23.1 is designed "to assure that the stockholder affords the corporation the opportunity to address an alleged wrong without litigation, to decide whether to invest the resources of the corporation in litigation, and to control any litigation which does occur." *Spiegel v. Buntrock,* Del.Supr., 571 A.2d 767 (1990).

This pre-suit demand is excused however where the plaintiff alleges particularized facts that, if true, would support a reasonable doubt that a majority of the directors upon whom demand would be made lack independence, or are interested or that the "challenged transaction was not [otherwise] the product of a valid exercise of business judgment." *Aronson v. Lewis,* Del.Supr., 473 A.2d 805 (1984).

***7** In this case, defendants argue either that demand upon DSC's board was *not* made prior to this action and that such demand is not excused, or, in the alternative, that plaintiff *did* make a demand upon the board and that such demand was properly refused. Accordingly, defendants conclude that plaintiff is unable to maintain this shareholder's derivative action.

The September 29, 1993 letter from plaintiff, appended to the complaint, clearly demonstrates that demand was made on plaintiff's claim of abdication, though plaintiff's other theories were not raised. Therefore, under Delaware's construction of the effect of a demand, the plaintiff may not now contend that demand was excused. *See Spiegel v. Buntrock, supra* at 775; *Rales v. Blasband,* Del.Supr., 634 A.2d 927 (1993).

Applying the legal test outlined above, which is designed to protect the board's ability to make a business judgment, to the amended complaint involves a subtlety. The claim of directorial abdication does not present an issue upon which the board's good faith business judgment could be conclusive. Thus, for this reason, amplified below, I conclude that the board's rejection of plaintiff's demand to seek rescission of the **Donald** Agreements does not bar this action. With respect to the other theories of recovery urged in the amended complaint (again excluding the proxy claim) I conclude for the reasons stated below that plaintiff is barred from pressing those claims in the name of the corporation at this time.

A.

The abdication claim asserts that corporate directors have authorized a contract that precludes them from meeting their statutory and fiduciary obligations. Such authorization would arguably constitute a violation of Section 141(a) of DGCL and at least a partial repudiation of *those fiduciary duties that directors owe directly* to the body of shareholders who legally designated them to hold office. Whether these contracts do violate Section 141 is a question of law directly concerning the legal character of the contract and its effect upon the directors. The question whether these contracts are valid or not does not fall into the realm of business judgment; it cannot be definitively determined by the informed, good faith judgment of the board. It must be determined by the court. *Cf. Blasius Indus., Inc. v. Atlas Corp.,* Del.Ch., 564 A.2d 651, 663 (1988). If this does not appear immediately obvious, I suggest that one read *Chapin v. Benwood,* Del.Ch., 402 A.2d 1205 (1979), *aff'd* 402 A.2d 1068 (1979) or *Abercrombie v. Davis,* Del.Ch., 123 A.2d 893 (1956), *rev'd on other grounds,* Del.Supr., 130 A.2d. 338 (1957) (which are briefly discussed below) and ask what result would have occurred in those cases if the boards involved had been asked to rescind the agreements there in question and had refused to do so on the belief, incorrect as it would have been, that they were valid agreements.

B.

In addition to the claim of abdication of responsibility, plaintiff claims in this suit that the **Donald** Agreements are the result of negligent inattention, constitute a waste of corporate assets,

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constitute an impermissible impediment to the emergence of any hostile change in corporate control and contemplate the payment of amounts that would constitute unenforceable penalties. There are obvious ripeness issues with respect to these claims, both as they relate to a possible future declaration of termination and to any possible future change in control transaction. No current obligation for DSC to make any of the payments that are claimed to be excessive has been alleged; nor is there alleged any interest of any person to acquire control of DSC that is impeded by the termination rights that the **Donald** Agreements contemplates. *See Brown v. Ferro. Corp.,* 763 F.2d 798 (6th Cir.), *cert. denied* 474 U.S. 947 (1985). *See, e.g., Stroud v. Milliken Enterprises, Inc.,* Del.Supr., 552 A.2d 476 (1989); *Schick, Inc. v. Amalgamated Clothing & Textile Workers,* Del.Ch., 533 A.2d 1235, 1239 (1987). But I pass over these points because I conclude that in making a demand upon the board, but not asserting these additional grounds on which to challenge the **Donald** Agreements plaintiff has, for the time being, waived them.

***8** If the internal corporate process contemplated by Rule 23.1 is to be engaged, certainly the complaining shareholder should present to the board for its consideration all of the concerns which he or she asserts justify board action. There is little to recommend a process in which a shareholder seeks board consideration of only some aspects of a transaction or puts forward only selected theories for board consideration, while reserving other theories for judicial consideration. Such a process would be neither efficient nor fair. Here plaintiff did not call to the board's attention these claims of waste etc. In making demand upon the board, plaintiff has in effect conceded that the board was in a position to consider and act upon his demand. *See Spiegel,* 571 A.2d at 775. By failing to present these matters to the board plaintiff has waived his ability to present them to this court. *Cf. Deibler v. Olde Dinner Bell Inn, Inc.,* Del.Supr., --- A.2d ---- (1995). This failure might be remedied by presenting these theories to the board for its consideration, but as matters now stand I conclude that plaintiff has no standing to raise any matters concerning the **Donald** Agreements other than the abdication theory and the proxy issue not addressed by this motion.

IV. The Alleged Abdication of Managerial Duties

Plaintiff's central claim is that the DSC board has, through the **Donald** Agreements, unlawfully *abdicated its power to manage the corporation.* He alleges that the delegation of power to **Donald** and the contract obligation to pay **Donald** substantial sums of money if the board, in **Donald's** unilateral good faith judgment, "unreasonably interferes" with his management, *effectively prohibits any management by the board* in violation of Section 141 of the DGCL.

A fundamental precept of Delaware corporation law is that it is the board of directors, and neither shareholders nor managers, that has ultimate responsibility for the management of the enterprise. *Cahall v. Lofland,* Del.Ch., 114 A. 224 (1921), *aff'd* 118 A. 1 (1922); *Campbell v. Loew's Inc.,* Del.Ch., 134 A.2d 852 (1957); *Mills Acquisition Co. v. Macmillan, Inc.,* Del.Supr., 559 A.2d 1261 (1989). Of course, given the large, complex organizations through which modern, multi-function business corporations often operate, the law recognizes that corporate boards, comprised as they traditionally have been of persons dedicating less than all of their attention to that role, cannot themselves manage the operations of the firm, but may satisfy their obligations by thoughtfully appointing officers, establishing or approving goals and plans and monitoring performance. *Cahall v. Lofland,* Del.Ch., 114 A.2d. 224 (1921). Thus Section 141(a) of DGCL expressly permits a board of directors to delegate managerial duties to officers of the corporation, except to the extent that the corporation's certificate of incorporation or bylaws may limit or prohibit such a delegation. [6]

***9** Absent specific restriction in the certificate of incorporation, the board of directors certainly has very broad discretion in fashioning a managerial structure appropriate, in its judgment, to moving the corporation towards the achievement of corporate goals and purposes. In designing and implementing such a structure, the board of course

may delegate such powers to the officers of the company as in the board's good faith, informed judgment are appropriate. But this power is not without limit. *See, e.g., Field v. Carlisle Corp.,* Del.Ch., 68 A.2d 817 (1949); *Clark Memorial College v. Monoghan Land Co.,* Del.Ch., 257 A.2d 234 (1969). The board may not either formally or effectively abdicate its statutory power and its fiduciary duty to manage or direct the management of the business and affairs of this corporation. Thus in *Abercrombie v. Davis,* Del.Ch., 123 A.2d 893 (1956) *rev'd on other grounds,* Del.Supr., 130 A.2d 338 (1957), this court voided a shareholders' agreement that purported to bind signatories in their director capacity:

> [b]ecause [the agreement] *tends to limit in a substantial way* the freedom of director decisions on matters of management policy, it violates the duty of each director to exercise his own best judgment on matters coming before the board.

Id. at 899 (emphasis added). *See also Chapin v. Benwood Foundation Inc.,* Del.Ch., 402 A.2d 1205 (1979) *aff'd,* Del.Supr., 415 A.2d 1068 (1980). This principle was recently restated by this court in *Canal Capital Corp. v. French,* Del.Ch., C.A. 11764, Berger, V.C. (July 2, 1992), which repeated a statement from *Chapin* that the court could not "give legal sanction to agreements which have the effect of removing from directors in a very substantial way their duty to use their own best judgment on management matters." *Id.*

Thus it is well established that while a board may delegate powers subject to possible review, it may not abdicate them.

Unlike the agreements or arrangements at issue in *Abercrombie* and *Chapin* or in *Field v. Carlisle Corp. and Clark Memorial College,* the **Donald** Agreements do not, under any circumstances, formally foreclose DSC's directors from exercising their business judgment. The **Donald** Agreements do not covenant that DSC directors will not "interfere" with **Donald's** management; rather they trigger rights to be paid if the board does "unreasonably interfere" with **Donald's** management.[7] In *Abercrombie* the directors were formally bound to vote as seven out of eight of them agreed. The directors in *Chapin* were formally bound to elect the person earlier designated as a successor trustee. Under the **Donald** Agreements, the DSC directors' actions could only be illegally hindered or effectively bound if the amount of money that DSC could owe to **Donald** in the event that he declared a termination were so great in relation to the wealth of DSC as to preclude reasonable directors from freely exercising their business judgment. Thus, unlike the agreements considered in *Abercrombie* and *Chapin,* the **Donald** Agreements do not formally preclude the DSC board from exercising its statutory powers and fulfilling its fiduciary duty. It is the alleged *practical effect* of these contracts that is said to constitute the abdication of directorial responsibility.

***10** I assume for purposes of resolving this dispute that, at least under some circumstances, that such an effect of an employment contract would render it voidable in equity.[8] On that assumption, and accepting the facts alleged as true and permitting all rational inferences in plaintiff's favor, the issue on this motion, with respect to the abdication claim, is whether the financial consequences of a possible termination determination by Mr. **Donald** might be such to DSC as substantially to deter defendants from exercising their statutory powers and fulfilling their fiduciary duties. The complaint however alleges very little about factual context of the **Donald** Agreements.

While the 43 page amended complaint repeatedly expresses the conclusion that the **Donald** Agreements are "irrevocable as a practical matter, *disabling the board from resuming the full exercise of its duty and authority* " (¶ 19); constitute "self-disablement" (¶ 25); or constitute an "overwhelming disincentive" to board action (¶ 39), the amended complaint contains little in the way of allegation of financial facts or circumstances that support those conclusions. The document

itself does not provide any basis to evaluate how significant the termination payments, which are stated as approximations (Am.Cplt. ¶¶ 26(a)(b), 27, 30, 31), might be to the Company. The figures that are pleaded (*see* p. 6 above) show annual direct compensation of approximately one million dollars, which would be continued for 6½ years in the event of termination without cause; show a rather conventional pension formula (3% of Base Salary plus bonuses for highest three years times number of years of service) with payments beginning after the Employment Term concludes; and alleges nothing specifically with respect to the value of the 200,000 long-term plan units except that upon the hypothetical happening of a change in control they might be worth $60 million. *See* note 10 *infra.* In all events these Unit rights are almost completely vested already; a declaration of constructive termination would itself do little more than permit the vesting and withdrawal of those sums that are already allocated to this account. Thus they could have little disincentive effect on board monitoring.

What can one make of this, even giving the benefits of all inferences to the pleader? Plaintiff omits to plead facts that if true would raise an issue concerning the financial significance to DSC of a triggering of **Donald's** termination rights. It is the alleged *significance* to DSC of the threat of that termination that forms the predicate of plaintiff's abdication theory. Yet he pleads insufficient facts concerning the size of the scope or financial condition of DSC to allege a *prima facie* case of *de facto* abandonment of director responsibility. *Cf. Haber v. Bell,* Del.Ch., 465 A.2d 353, 359 (1983) (motion to dismiss granted where "... there [were] no allegations of facts which show that the options are of such gross disparity ... as to make Board approval appear to be of the type no reasonable businessman could approve").

***11** A close inspection of the attachments to the complaint,[9] however, (in particular the Proxy Statement of March 31, 1994) shows that in 1993 DSC had revenues of $730.8 million and earnings of $81.7 million and that during that year, debt was reduced from $140 million to $70 million. The corporation had 55.7 million shares outstanding as of March 1, 1994 and a market capitalization of approximately $2.8 billion at that time. These facts are dramatic in light of the conclusory contentions made by plaintiff. They corroborate the conclusion that plaintiff has failed to allege a claim upon which relief could be granted. In the light that they throw, one can see that the amended complaint charges that directors of a large public corporation with $81 million in earnings last year will, as a practical matter, face "an overwhelming disincentive" to monitor Mr. **Donald's** performance because such monitoring might cause Mr. **Donald** to decide to claim board "interference" and possibly allow a termination of his contract obligations. This, in turn, would occasion an obligation to continue to make annual payments to **Donald** of something more than a million dollars, for six and one-half years.[10] Assuming the facts alleged were proven (indeed drawing all inferences in plaintiff's favor, one could assume multiples of these numbers without changing the analysis) and assuming that the principle of *Abercrombie, Chapin,* and other such cases extend to agreements that, as a practical matter rather than formally, have the effect of preventing the board from exercising its power to continue to govern the corporate enterprise, nevertheless, in this instance not enough has been pleaded to possibly permit a fact finder to infer that the financial consequences flowing from the **Donald** Agreements would be such to DSC as to render the **Donald** Agreements a *de facto* abdication of directorial obligation. In these circumstances I conclude that it is appropriate to dismiss this claim.

In concluding, I note, however, that the plaintiff's abdication case is given substantial superficial appeal by the foolish use in Section 1(f)(vii) of the Employment Agreement of the concept of "unreasonable interference, in the good faith judgment of the Executive, by the Board ... in the Executive's carrying out of his duties and responsibilities." This ill-conceived provision does give rise to the inference that the outside corporate directors of DSC, and Mr. **Donald**, or the professional advisors of both, have fundamentally misunderstood the basic structure and requirements of the law governing corporate organization and governance. Ultimately, it is the responsibility and duty of the elected board to determine corporate

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goals, to approve of strategies and plans to achieve those goals and to monitor progress towards achieving them. The insertion of the concept of board "interference" into the employment contract of a senior officer clouds that responsibility; it addresses what may be a valid negotiating point-a senior officer's understandable desire that he be accorded substantial freedom in achieving goals set by persons to whom he is accountable-in an unskillful way that raises problems. In this instance the financial consequences (as alleged in the amended complaint) of a contract termination under this language would be such, that, in light of the size, scope and substantial profitability of the enterprise, one could not possibly conclude that the board of directors would be substantially impeded in exercising its statutory authority by the prospects of possibly triggering those consequences. Yet the concept itself is badly flawed and could lead to problems in other settings.

***12** Thus, for the foregoing reasons, I conclude that with the exception of the claim arising from the March 1994 Proxy Statement, which I do not address, the amended complaint fails to allege facts which if true would entitle plaintiff to any judicial relief.

It is so Ordered.

All Citations

Not Reported in A.2d, 1995 WL 54441, 20 Del. J. Corp. L. 757

Footnotes

1 Plaintiff's claims that the board wrongfully refused his demand and provided materially misleading proxy materials are not asserted against Defendants Leake and Watson as they were no longer on DSC's board when these alleged events occurred.

2 Plaintiff asserts that even before the contracts were approved the board had abdicated its management duties. Plaintiff, however, has not alleged any facts to support such a conclusion.

3 The instances in which DSC may terminate **Donald** for "Cause" are narrowly defined. Only if **Donald** has been convicted of a felony "involving moral turpitude" or if his "serious, willful gross misconduct or willful gross neglect of duties ... has resulted, or in all probability is likely to result, in material economic damage to [DSC]" does the corporation have cause to terminate his contract, "*provided that* no action or failure to act by [**Donald**] will constitute "Cause" if [**Donald**] believed in good faith that such action or failure to act was in [DSC's] best interest...." Am.Cplt.Ex. 1 § 1(d)(i) and (ii) (emphasis added).

4 **Donald** is entitled to exercise these units at will by written notice to DSC and thereby receive their cash value. The units, however, will only become fully vested (100%) before December 31, 1995, in the event of a change in control *or in the event of a termination without Cause.* Only 66 $^{2}/_{3}$% of the units were vested at the time the amended complaint was filed. Also if **Donald** exercises them at any time other than pursuant to a change in control, he will only be eligible to receive the "Cumulative Unit Value" as defined in the Long-Term Plan.

5 *See* Am.Cplt., Ex. 3 at § 8.3. In general, a Change in Control exists if (a) there is a merger, reorganization or consolidation in which there is a substantial change in the identity of stockholders and the proportion of their ownership; (b) a person or affiliated group acquires more than twenty percent of the company's stock, unless expressly excepted by the Employment Agreement or the Long-Term Plan; or (c) the members of the board as constituted on January 1, 1990 ("Incumbent Board") cease to "constitute at least a majority of the [b]oard; provided, however, that any individual becoming a director subsequent to [January 1, 1990] whose election, or nomination for election by the [c]ompany's stockholders was approved by a vote of at least two-thirds of the directors then constituting the Incumbent Board shall be considered as though such individual were a member of the Incumbent Board," unless such individual assumed office pursuant to an actual or threatened proxy contest. Am.Cplt., Ex. 3 at 2.4. The last of these definitions, which in context can be seen as placing a large (allegedly $60 million) cash tariff on the shareholder's free exercise of their right to elect the board, raises apparent legal issues. *See Guiricich v. Emtrol Corp.,* Del.Supr., 449 A.2d 232, 239 (1982); *Paramount Communications Inc. v. QVC Network, Inc.,* Del.Supr., 637 A.2d 34, 42 (1993); *Blasius Indus.*

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Inc. v. Atlas Corp., Del.Ch., 564 A.2d 651 (1988). As it is not alleged that any party seeks to run a proxy context at this time, and as plaintiff does not otherwise raise any franchise implications of the "incumbent board" (sometimes referred to as "continuing directors") provision in the "Change in Control" definition, there is no occasion for this court to inquire into this subject further at this point.

6 The Amended Complaint alleges that DSC's certificate of incorporation and bylaws prohibit the board from delegating its duty to manage. Plaintiff cites the difference between the language of the statute ("managed by *or under the direction of* a board of directors") and the language of the certificate and bylaws ("managed and controlled *by* a board of directors") to support the proposition that DSC specifically does not permit any delegation, even if the board were to dutifully supervise the exercise of the delegated power. (emphasis added) In my opinion the 1974 amendment to DGCL § 141(a) that added the phrase "or under the direction of" was simply a refinement that clarified a point hardly in need of very much clarification. Prior to the amendment it was clear that a board of directors could meet its management responsibilities by appropriately appointing and monitoring, corporate officers and exercising informed business judgment with respect to corporate goals and performance. *Cahall v. Lofland,* Del.Ch., 114 A. 224, 229 (1921) ("supervision, direction and control"). The 1974 Amendment did not change the substantive law. *See* 1 R. Franklin Balotti and Jesse A. Finkelstein, *The Delaware Law of Corporations and Business Organizations,* § 4.8 (2d. ed. 1990, 1995 Supp.). Therefore plaintiffs attempt to state a claim based upon a difference in the DSC certificate and the amended Section 141(a) must fail.

7 Subject to his "good faith" requirement and a contractual opportunity to arbitrate any claims of "interference."

8 Among such circumstances would be the foreseeability of the effect at the time the contract was approved by the board. An even more difficult case would be presented where the terms of a CEO's employment contract came to have the practical effect of precluding the board from exercising its statutory powers and satisfying its fiduciary duty, but that effect was not reasonably foreseeable at the time the contract rights were negotiated at arm's-length. Such a case would present a clash between a CEO's contract rights and the board's fiduciary duty. *Compare Paramount Communications v. QVC Network,* Del.Supr., 637 A.2d 34 (1993) (buyers contract right to "lock-up" abrogated); *ConAgra, Inc. v. Cargill, Inc.,* Neb.Supr., 382 N.W.2d 576 (1986).

9 For cases in which this court and others have on Rule 12(b) referred to documents appended to the complaint *see, e.g., Lewis v. Straetz,* Del.Ch., C.A. No. 7859, Hartnett, V.C., Mem.Op. at 6-10 (Feb. 12, 1986); *Patents Management Corp. v. O'Connor,* Del.Ch., C.A. No. 110, Walsh, V.C., Ltr.Op. at 2-3 (June 10, 1985); *Homart Dev. Co. v. Sigman,* 11th Cir., 868 F.2d 1556 (1989); *Durning v. First Boston Corp,* 9th Cir., 815 F.2d 1265, 1267, *cert. denied,* 484 U.S. 944 (1987); *Amfac Mortgage Corp. v. Arizona Mall of Tempe, Inc.,* 583 F.2d 426 (9th Cir.1978). *See also* Ch.Ct.R. 10(c) stating that exhibits to a pleading constitute a part of such pleading.

10 Plaintiff alleges the future payments if they had been triggered in 1993 would have totaled $8,657,864, not including gross-up obligations, which I accept for these purposes. The large number that plaintiff alleges ($60 million) is great indeed but arises only in connection with a change in control of DSC and does not logically relate to the theory of abdication.

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Original Image of 46 A.3d 313 (PDF)

KeyCite Red Flag - Severe Negative Treatment
Judgment Reversed by Pyott v. Louisiana Mun. Police Employees' Retirement System, Del.Supr., April 4, 2013

46 A.3d 313
Court of Chancery of Delaware.

LOUISIANA MUNICIPAL POLICE EMPLOYEES' RETIREMENT SYSTEM and U.F.C.W. Local 1776 & Participating Employers Pension Fund, Plaintiffs,
v.
David PYOTT, Herbert W. Boyer, Louis J. Lavigne, Gavin S. Herbert, Stephen J. Ryan, Leonard D. Schaeffer, Michael R. Gallagher, Robert Alexander Ingram, Trevor M. Jones, Dawn E. Hudson, Russell T. Ray, and Deborah Dunsire, Defendants,
and
Allergan, Inc., Nominal Defendant.

C.A. No. 5795–VCL.
|
Submitted March 29, 2012.
|
Decided June 11, 2012.

Synopsis

Background: Stockholder brought derivative action against individual directors of pharmaceutical corporation after corporation pled guilty to criminal misdemeanor misbranding and paid civil and criminal fines. Directors moved to dismiss.

Holdings: The Chancery Court, Laster, Vice Chancellor, held that:

[1] plaintiff stockholder in instant derivative action was not in privity with plaintiff stockholder in prior derivative action brought in foreign jurisdiction, and thus prior action did not have preclusive effect on instant action under collateral estoppel doctrine, and

[2] stockholders alleged direct connection between board and business plan allegedly premised on illegal activity, as required to plead substantial threat of liability.

Motion denied.

West Headnotes (21)

[1] **Corporations and Business Organizations** Derivative actions

101 Corporations and Business Organizations
101XIII Foreign Corporations
101XIII(A) In General

101k3186 Subjection to Requirements as Imposed by State of Incorporation; What Law Governs
101k3191 Derivative actions

Whether stockholders of prior and successive derivative litigation are sufficiently in privity with the corporation and each other, as would allow defendant in successive proceeding to assert collateral estoppel as defense to stockholders' derivative action, is a matter of substantive state law governed by the internal affairs doctrine.

Cases that cite this headnote

[2] Corporations and Business Organizations Internal affairs doctrine in general

101 Corporations and Business Organizations
101XIII Foreign Corporations
101XIII(A) In General
101k3186 Subjection to Requirements as Imposed by State of Incorporation; What Law Governs
101k3188 Internal affairs doctrine in general

Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation.

1 Cases that cite this headnote

[3] Corporations and Business Organizations Internal affairs doctrine in general

101 Corporations and Business Organizations
101XIII Foreign Corporations
101XIII(A) In General
101k3186 Subjection to Requirements as Imposed by State of Incorporation; What Law Governs
101k3188 Internal affairs doctrine in general

The "internal affairs doctrine" is a conflict of laws principle which recognizes that only one state should have the authority to regulate a corporation's internal affairs, that is, matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders.

1 Cases that cite this headnote

[4] Corporations and Business Organizations Derivative actions

101 Corporations and Business Organizations
101XIII Foreign Corporations
101XIII(A) In General
101k3186 Subjection to Requirements as Imposed by State of Incorporation; What Law Governs
101k3191 Derivative actions

Whether, under collateral estoppel doctrine, a stockholder in a Delaware corporation can sue derivatively after another stockholder attempted to plead demand futility in a separate action is governed uniformly by Delaware law pursuant to the internal affairs doctrine.

Cases that cite this headnote

[5] Judgment Operation and effect

228 Judgment
228XVII Foreign Judgments

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228k829 Effect of Judgments of United States Courts in State Courts
228k829(3) Operation and effect
Plaintiff stockholder in instant derivative action was not in privity with plaintiff stockholder in prior derivative action brought in federal court, and thus prior action did not have preclusive effect on instant action under collateral estoppel doctrine, where prior action was dismissed for failure to plead demand futility as required by procedural rule providing for derivative actions, and stockholder in instant action was attempting to plead demand excusal. Chancery Court Rule 23.1.

4 Cases that cite this headnote

[6] **Corporations and Business Organizations** Sufficiency of Refusal

Corporations and Business Organizations Excuse for Failure to Demand;Futility

101 Corporations and Business Organizations
101VIII Derivative Actions;Suing or Defending on Behalf of Corporation
101VIII(A) In General
101k2035 Demanding Action and Refusal of Corporation, Directors or Officers to Act
101k2039 Sufficiency of Refusal
101k2039(1) In general
101 Corporations and Business Organizations
101VIII Derivative Actions;Suing or Defending on Behalf of Corporation
101VIII(A) In General
101k2035 Demanding Action and Refusal of Corporation, Directors or Officers to Act
101k2040 Excuse for Failure to Demand;Futility
101k2040(1) In general
A stockholder whose litigation efforts are opposed by the corporation does not have authority to sue on behalf of the corporation until there has been a finding of demand excusal or wrongful refusal.

Cases that cite this headnote

[7] **Corporations and Business Organizations** Nature and Form of Remedy

101 Corporations and Business Organizations
101VIII Derivative Actions;Suing or Defending on Behalf of Corporation
101VIII(A) In General
101k2022 Nature and Form of Remedy
101k2023 In general
The nature of a derivative action is two-fold; first, it is the equivalent of a suit by the shareholders to compel the corporation to sue, and second, it is a suit by the corporation, asserted by the shareholders on its behalf, against those liable to it.

3 Cases that cite this headnote

[8] **Corporations and Business Organizations** Ability to represent other shareholders

Judgment Operation and effect

101 Corporations and Business Organizations
101VIII Derivative Actions;Suing or Defending on Behalf of Corporation
101VIII(B) Derivative Actions by Shareholders Against Directors, Officers, or Agents
101k2077 Persons Entitled to Sue or Defend;Standing
101k2082 Ability to represent other shareholders

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228 Judgment
228XVII Foreign Judgments
228k829 Effect of Judgments of United States Courts in State Courts
228k829(3) Operation and effect
Stockholder plaintiffs in prior federal derivative action did not adequately represent corporation, and thus prior action did not have preclusive effect, under collateral estoppel doctrine, on subsequent derivative action by different stockholder plaintiffs, even though prior action was dismissed for failure to plead demand futility as required by procedural rule providing for derivative actions, where prior action was instituted by fast-filing stockholder with nominal stake in litigation less than 48 hours after announcement of corporation's settlement regarding civil and criminal fines. Chancery Court Rule 23.1.

5 Cases that cite this headnote

[9] **Corporations and Business Organizations** Nature and Form of Remedy

101 Corporations and Business Organizations
101VIII Derivative Actions;Suing or Defending on Behalf of Corporation
101VIII(A) In General
101k2022 Nature and Form of Remedy
101k2023 In general
In a derivative suit, a stockholder seeks to displace the board's authority.

1 Cases that cite this headnote

[10] **Corporations and Business Organizations** Grounds of actions or defense

101 Corporations and Business Organizations
101VIII Derivative Actions;Suing or Defending on Behalf of Corporation
101VIII(B) Derivative Actions by Shareholders Against Directors, Officers, or Agents
101k2083 Grounds of actions or defense
A stockholder cannot displace a board's authority through a derivative action simply by describing a calamity and alleging that it occurred on the directors' watch; without a connection to the board, a corporate calamity will not lead to director liability.

3 Cases that cite this headnote

[11] **Corporations and Business Organizations** Sufficiency of bill, petition, or complaint

101 Corporations and Business Organizations
101VIII Derivative Actions;Suing or Defending on Behalf of Corporation
101VIII(B) Derivative Actions by Shareholders Against Directors, Officers, or Agents
101k2095 Pleading
101k2102 Sufficiency of bill, petition, or complaint
To plead a sufficient connection between corporate trauma and the board, as required to support a derivative action, the plaintiff's first and most direct option is to allege with particularity actual board involvement in a decision that violated positive law.

6 Cases that cite this headnote

[12] **Corporations and Business Organizations** Fiduciary Duties as to Management of Corporate Affairs in General

Corporations and Business Organizations ⊶ Grounds of actions or defense

101 Corporations and Business Organizations
101VII Directors, Officers, and Agents
101VII(D) Rights, Duties, and Liabilities as to Corporation and Its Shareholders or Members
101k1840 Fiduciary Duties as to Management of Corporate Affairs in General
101k1841 In general
101 Corporations and Business Organizations
101VIII Derivative Actions;Suing or Defending on Behalf of Corporation
101VIII(B) Derivative Actions by Shareholders Against Directors, Officers, or Agents
101k2083 Grounds of actions or defense

A corporate board's decision to act and the conscious decision not to act are equally subject to review under traditional fiduciary duty principles and equally able to create the requisite connection to the board required for a derivative action arising out of a calamity.

1 Cases that cite this headnote

[13] Corporations and Business Organizations ⊶ Grounds of actions or defense

101 Corporations and Business Organizations
101VIII Derivative Actions;Suing or Defending on Behalf of Corporation
101VIII(B) Derivative Actions by Shareholders Against Directors, Officers, or Agents
101k2083 Grounds of actions or defense

If a corporation suffers losses proximately caused by illegal conduct, and if the directors failed to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, then there is a sufficient connection between the occurrence of the illegal conduct and board level action or conscious inaction to support liability in a derivative action.

2 Cases that cite this headnote

[14] Corporations and Business Organizations ⊶ Oversight

101 Corporations and Business Organizations
101VII Directors, Officers, and Agents
101VII(D) Rights, Duties, and Liabilities as to Corporation and Its Shareholders or Members
101k1840 Fiduciary Duties as to Management of Corporate Affairs in General
101k1846 Oversight

Generally where a derivative claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation, only a sustained or systematic failure of the board to exercise oversight, such as an utter failure to attempt to assure a reasonable information and reporting system exists, will establish the lack of good faith that is a necessary condition to liability.

1 Cases that cite this headnote

[15] Corporations and Business Organizations ⊶ Sufficiency of bill, petition, or complaint

101 Corporations and Business Organizations
101VIII Derivative Actions;Suing or Defending on Behalf of Corporation
101VIII(B) Derivative Actions by Shareholders Against Directors, Officers, or Agents
101k2095 Pleading
101k2102 Sufficiency of bill, petition, or complaint

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Because a plaintiff must plead a connection to the board to support a derivative action based on a calamity to corporation, only the extremely rare complaint will be able to establish the necessary linkage without referring to internal corporate documents.

Cases that cite this headnote

[16] **Corporations and Business Organizations** ⊶ Sufficiency of allegations of demand and refusal

101 Corporations and Business Organizations
101VIII Derivative Actions;Suing or Defending on Behalf of Corporation
101VIII(A) In General
101k2045 Pleading
101k2050 Sufficiency of allegations of demand and refusal

The requirement of factual particularity of a plaintiff's demand, as would support a derivative action, does not entitle a court to discredit or weigh the persuasiveness of well-pled allegations; the well-pleaded factual allegations of the derivative complaint are accepted as true on a motion to dismiss for failure to comply with procedural rule for derivative actions. Chancery Court Rule 23.1.

2 Cases that cite this headnote

[17] **Corporations and Business Organizations** ⊶ Allegations of excuse for failure to demand; futility

101 Corporations and Business Organizations
101VIII Derivative Actions;Suing or Defending on Behalf of Corporation
101VIII(A) In General
101k2045 Pleading
101k2051 Allegations of excuse for failure to demand;futility

To comply with procedural rule requiring plaintiff in a derivative action to allege with particularity that a demand on board to sue would have been futile because of director interest or risk of liability, a plaintiff need not plead particularized facts sufficient to sustain a judicial finding either of director interest or lack of director independence or other disabling factor. Chancery Court Rule 23.1.

12 Cases that cite this headnote

[18] **Corporations and Business Organizations** ⊶ Allegations of excuse for failure to demand; futility

101 Corporations and Business Organizations
101VIII Derivative Actions;Suing or Defending on Behalf of Corporation
101VIII(A) In General
101k2045 Pleading
101k2051 Allegations of excuse for failure to demand;futility

To show that a director faces a substantial risk of liability, in order to comply with procedural rule requiring plaintiff in a derivative action to allege with particularity that a demand on board to sue would have been futile because of director interest or risk of liability, the plaintiff does not have to demonstrate a reasonable probability of success on the claim; plaintiffs need only make a threshold showing, through the allegation of particularized facts, that their claims have some merit. Chancery Court Rule 23.1.

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6 Cases that cite this headnote

[19] **Corporations and Business Organizations** Business judgment rule in general

101 Corporations and Business Organizations
101VII Directors, Officers, and Agents
101VII(D) Rights, Duties, and Liabilities as to Corporation and Its Shareholders or Members
101k1840 Fiduciary Duties as to Management of Corporate Affairs in General
101k1842 Business judgment rule in general

Under the "business judgment rule," the business outcome of an investment project that is unaffected by director self-interest or bad faith, cannot itself be an occasion for director liability in a derivative action.

Cases that cite this headnote

[20] **Corporations and Business Organizations** Fiduciary Duties as to Management of Corporate Affairs in General

101 Corporations and Business Organizations
101VII Directors, Officers, and Agents
101VII(D) Rights, Duties, and Liabilities as to Corporation and Its Shareholders or Members
101k1840 Fiduciary Duties as to Management of Corporate Affairs in General
101k1841 In general

Under state law, a fiduciary may not choose to manage an entity in an illegal fashion, even if the fiduciary believes that the illegal activity will result in profits for the entity. 8 West's Del.C. §§ 101, 102.

Cases that cite this headnote

[21] **Corporations and Business Organizations** Allegations of excuse for failure to demand; futility

101 Corporations and Business Organizations
101VIII Derivative Actions;Suing or Defending on Behalf of Corporation
101VIII(B) Derivative Actions by Shareholders Against Directors, Officers, or Agents
101k2095 Pleading
101k2101 Allegations of excuse for failure to demand;futility

Stockholders alleged direct connection between board and business plan allegedly premised on illegal activity, as required to plead substantial threat of liability so as to defeat individual board members' motion to dismiss for failure to comply with procedural rule requiring derivative action plaintiff to allege with particularity that a demand on board to sue would have been futile because of director interest or risk of liability, in stockholders' derivative action against board members arising out of pharmaceutical corporation's entry into settlement agreement involving civil and criminal fines for marketing of off-label uses of drug, where stockholders' complaint pleaded that board discussed and approved series of annual strategic plans that involved off-label applications of drug, that board closely monitored successful sales of drug at rates far exceeding market for on-label uses, and that board kept business plan in place even after warnings of regulatory exposure, and complaint did not merely allege that such misconduct took place but referenced internal corporate books and records. Chancery Court Rule 23.1.

9 Cases that cite this headnote

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OPINION

LASTER, Vice Chancellor.

On September 1, 2010, Allergan, Inc. entered into a settlement with the United States Department of Justice pursuant to which Allergan pled guilty to criminal misdemeanor misbranding and paid a total of $600 million in civil and criminal fines. Various specialized plaintiffs' law firms quickly filed derivative actions in both this Court and in the United States District Court for the Central District of California (the “California Federal Court”).

Litigation proceeded in both courts. The California Federal Court initially dismissed a consolidated complaint pursuant to Rule 23.1 without prejudice, then later dismissed an amended and consolidated complaint pursuant to Rule 23.1 with prejudice (the “California Judgment”). Meanwhile, I postponed briefing on the defendants' motions to dismiss to accommodate the efforts of one stockholder, U.F.C.W. Local 1776 & Participating Employers Pension Fund (“UFCW”), to obtain books and records using Section 220 of the General Corporation Law, 8 *Del. C.* § 220. UFCW subsequently intervened in this action, and the plaintiffs jointly filed an 84–page, 241–paragraph Verified Second Amended Derivative Complaint dated July 8, 2011 (the “Complaint”).

The defendants have moved to dismiss the Complaint. First, they say that the California Judgment mandates dismissal with prejudice under the doctrine of collateral estoppel. Second, they say that even if reviewed independently, the Complaint fails to plead demand futility under Rule 23.1. Third, they say that the Complaint fails to state a claim under Rule 12(b)(6). I reject these arguments and deny the defendants' motions.

***317 I. FACTUAL BACKGROUND**

The facts for purposes of the motions to dismiss are drawn from the Complaint and the documents it incorporates by reference. The incorporated documents include publicly available information, such as a government sentencing memorandum, and non-public books and records that UFCW obtained by using Section 220, such as Allergan's internal board-approved strategic plans and warning letters from the U.S. Food and Drug Administration (the “FDA”). The Complaint contains numerous particularized

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factual allegations from which inferences reasonably could be drawn in favor of either the plaintiffs or the defendants. At this stage of the case, the plaintiffs receive the benefit of all reasonable inferences.

A. Allergan And The Growth Of Botox

Nominal defendant Allergan is a Delaware corporation that develops and commercializes specialty pharmaceuticals, biologics, and medical devices. Allergan's stock trades on the New York Stock Exchange under the symbol "AGN." The twelve individual defendants comprised Allergan's board of directors (the "Board") at the time this action was initiated. Defendant Pyott has served as Allergan's CEO since 1998 and as Chairman of the Board since 2001. Defendants Boyer, Gallagher, Herbert, and Schaeffer have served as outside directors since before 2000. Defendants Ryan, Ray, and Jones joined the board as outside directors in 2002, 2003, and 2004, respectively. Defendants Lavigne and Ingram joined the board in 2005. Defendants Dunsire and Hudson joined the board in 2006 and 2008, respectively.

Allergan manufactures Botox, a drug widely known for its muscle-relaxing properties. The trade name derives from its active ingredient, the neurotoxin botulinum toxin type A. The government settlement and this opinion address only Botox Therapeutic; they do not address its better-known sibling, Botox Cosmetic, which has its own FDA-approved label and drug code.

The FDA first approved Botox for therapeutic use in 1989 for treating two eye muscle disorders: strabismus (crossed eyes) and blepharospasm (abnormal spasm of the eyelids). In December 2000, the FDA approved Botox for treating pain associated with cervical dystonia (involuntary neck muscle contraction). In July 2004, the FDA approved the product for treating severe primary axillary hyperhidrosis (underarm sweating). Not until 2010 would the FDA approve two additional treatments: upper-limb spasticity (approved in March 2010) and migraine headaches (approved in October 2010).

A small market existed for the limited Botox uses approved by the FDA before 2010. Treating physicians, however, were not limited to FDA-approved applications. In the United States, a physician may prescribe an approved pharmaceutical product for any use, including uses not approved by the FDA. Prescribing a pharmaceutical product for an FDA-approved use is referred to as "on-label" use; prescribing the same product for an unapproved use is referred to as "off-label" use. " 'Off-label use is widespread in the medical community and often is essential to giving patients optimal medical care, both of which medical ethics, FDA, and most courts recognize.' " *Buckman Co. v. Plaintiffs' Legal Comm.,* 531 U.S. 341, 351 n. 5, 121 S.Ct. 1012, 148 L.Ed.2d 854 (2001) (quoting James M. Beck & Elizabeth D. Azari, *FDA, Off–Label Use, and Informed Consent: Debunking Myths and Misconceptions,* 53 Food & Drug L.J. 71, 72 (1998)).

Because a physician legally can prescribe a product for off-label use, a manufacturer ***318** legally can sell a product notwithstanding its potential off-label use. It is *illegal,* however, for a manufacturer to *market* a drug for off-label use. Under the Food, Drug, and Cosmetics Act, 21 U.S.C. §§ 301 *et seq.,* the Public Health Service Act, 42 U.S.C. §§ 262 *et seq.,* and their implementing regulations, drug manufacturers cannot market or promote drugs for uses that the FDA has not approved. *See, e.g.,* 21 U.S.C. § 331(a), (d); 42 U.S.C. § 262(a)(1), (b); 21 C.F.R. § 601.12.

Allergan understood the critical distinction between off-label sales and marketing. Allergan's 2004 Annual Report summarized the regulatory scheme as follows:

> Physicians may prescribe pharmaceutical and biologic products for uses that are not described in a product's labeling or differ from those tested by us and approved

> by the FDA. While such "off-label" uses are common and the FDA does not regulate a physician's choice of treatment, the FDA does restrict a manufacturer's communications on the subject of off-label use. Companies cannot actively promote FDA-approved pharmaceutical or biologic products for off-label uses.... If ... our promotional activities fail to comply with the FDA's regulations or guidelines, we may be subject to warnings from, or enforcement action by, the FDA or another enforcement agency.

This derivative action arises out of Allergan's failed efforts (as demonstrated by the guilty plea and government settlement) to walk the fine line between off-label sales and off-label marketing.

B. Allergan Provides Extensive Support For Off–Label Sales.

Allergan strongly advocated expanded uses for Botox and supported off-label Botox sales with a phalanx of initiatives. The company sponsored Botox seminars and presentations about off-label uses, founded and financed organizations that advocated off-label uses, provided support services for physicians seeking reimbursement for off-label uses, and lobbied government healthcare programs to expand reimbursement for off-label uses. Allergen CEO Pyott was such a vocal advocate for the drug that he earned the nickname "Mr. Botox."

Most importantly, Allergan cultivated relationships with physicians, a strategy it considered critical to increasing off-label Botox use. Allergan instituted a Physician Partnership Program in which it paid selected physicians to be travelling mentors to promote Botox use among their peers, and it funded physician "preceptorships" in which Allergan personnel shadowed participating physicians. Allergan monitored physician prescription writing, identified those doctors who prescribed high levels of Botox, and recruited them for its Physician Partnership Program. Allergan also funded continuing medical education programs, seminars, and promotional dinners. In 2006 alone, the company sponsored more than 1,200 physician speaker programs.

Allergan recognized that growth in off-label Botox use largely depended on physicians receiving reimbursement from healthcare programs. To facilitate reimbursement, Allergan employed Provider Reimbursement Account Managers to counsel physicians concerning off-label Botox prescriptions. The Provider Reimbursement Account Managers audited physician billing records and reviewed the payments physicians received to assist in maximizing reimbursement for off-label use. Allergan maintained a physician-assistance hotline that doctors could call for additional off-label reimbursement advice and billing assistance. To provide a financial incentive for physicians to write more ***319** off-label prescriptions despite reimbursement limitations, Allergan implemented a Temporary Price Allowance Program. This program gave selected physicians below-invoice discounts to create a profitable spread between the physician's acquisition cost and the Medicare reimbursement rate. Allergan's written strategic plan for 1997–2001 cited the "U.S.-Reimbursement assistance" program as one of the reasons "*Why Customers Buy From Us Now.*" German Aff. Ex. D, Written Plan, at 59 [hereinafter the Written Plan].

Allergan also financed a number of organizations to support off-label Botox use. Mitchell Bren, Allergan's chief scientific officer for Botox, founded WE MOVE, the Worldwide Education and Awareness for Movement Disorders Organization. WE MOVE distributed medical literature to physicians that provided dosing guidelines for off-label uses, including a "Suggested Pediatric BOTOX® Dosing" manual. Allergan also funded the Neurotoxin Institute, an on-line organization that disseminated information about off-label Botox uses. Although funded by Allergan, the Institute described itself on its website as "a multidisciplinary

organization created to serve as a comprehensive *independent* source of information related to the basic science and the clinical applications of neurotoxins." Compl. ¶ 78 (emphasis added; internal quotation omitted). Allergan financed another entity, the Alliance for Patient Access, whose mission was to reduce coverage barriers to reimbursement for off-label Botox uses.

C. The Board Approves And Oversees The Strategic Plan.

The Allergan Board played an active role in planning and monitoring the growth of Botox, which was one of the company's most promising products. From at least 1997, the Board discussed and approved a series of annual strategic plans that sought to expand off-label Botox sales. A slide deck summarizing the 1997–2001 Strategic Plan listed "BOTOX—Spasticity, migraine, and pain" as one of Allergan's "Top Corporate Priorities." German Aff. Ex. D, Plan Slides, at 10 [hereinafter the Plan Slides]. At the time, those uses were not approved by the FDA. The slides further noted that Botox "represent[s] immediate growth" for Allergan and that the "[e]xpansion strategy enables Allergan to maximize ... BOTOX® *now.*" *Id.* at 11. The plan noted that Botox would enable Allergan to compete in the "pain market" and "migraine headache market," which were estimated to grow to a combined $6 billion by 2007. Written Plan at 3. The plan described Botox as having "tremendous growth potential as we fund opportunities ... such as spasticity, pain, migraine, and tension headache." *Id.* Each remained an off-label use until at least 2010.

The Board regularly monitored Botox sales. For example, at a September 2002 Board meeting, Pyott "reviewed BOTOX® growth in average daily sales." Compl. ¶ 15. At a July 2003 Board meeting, Pyott "discussed BOTOX® sales growth over last 12 months, the then-current sales mix of BOTOX® Therapeutic (58%) v. BOTOX® Cosmetic (42%), intra-therapeutic growth rates for BOTOX®, and BOTOX® capacity utilization and scenarios." *Id.*

D. Government Scrutiny Of Allergan's Botox Programs

Allergan first drew government scrutiny for its Botox initiatives on August 22, 2001, when Allergan received a warning letter from the FDA. The letter noted that the FDA had "reviewed [Allergan] promotional activities and materials and has concluded that they are misleading and lacking in fair balance...." German Aff. Ex. F. The letter requested that Allergan take ***320** "prompt action to correct ... violations like those outlined in this letter." *Id.* Allergan received a warning letter addressing misleading advertising for Botox Cosmetic in June 2003. German Aff. Ex. G.

Despite the FDA warnings, Allergan continued to drive Botox sales, which increased rapidly. Between 2000 and 2004, net sales of Botox grew between 25% and 42% annually, despite being approved by the FDA for only four limited uses. Compl. ¶ 53. Off-label sales skyrocketed. Between 1999 and 2006, spasticity sales grew by 332%; headache sales grew by 1,407%; and pain sales grew by 504%. *Id.* ¶ 12. By 2005, Botox accounted for 33% of Allergan's total net sales. *Id.* ¶ 170.

E. The Schim Incident

On September 21, 2006, the FDA sent a letter to Allergen concerning off-label marketing during a presentation by an Allergan-sponsored speaker, Dr. Jack Schim. Dr. Schim is the co-director of the Headache Center of Southern California and was a frequent participant in Allergan's sponsored-physician speaker program.

On October 24, 2006, Allergan's General Counsel Douglas S. Ingram advised the Board by email about the FDA inquiry. Ingram noted that Dr. Schim's speech "contained a large volume of information on the use of Botox for the treatment of headache," which was an off-label use at the time. German Aff. Ex. E.

Ingram reminded the directors that the dinner programs were "directly funded, hosted, and controlled by Allergan" and that "the presentations are considered commercial promotion and Allergan is responsible for their content." *Id.* Ingram reported that

> [u]pon our internal investigation into this dinner meeting, it was discovered that Dr. Schim had been provided the approved ... slide deck but had, instead, used another deck of slides that were not approved [by Allergan].... These slides, many of which presumably came from continuing medical education events, contained some information about the mechanism of action of Botox and some information on the use of Botox for the treatment of cervical dystonia. However, the deck also contained a large volume of information on the use of Botox for the treatment of headache. *Moreover, we have discovered that there were a total of 8 such dinner meetings over the last 12 months at which Dr. Schim presented these or similar slides.*

Id. (emphasis added).

Ingram advised the Board that "[i]t appears that the primary basis for this failure to comply with policy related to a perceived lack of responsibility within the sales and marketing organization." *Id.* According to Ingram, "[t]he sales representative and sales manager knew or should have known that [unapproved] slides were being used but apparently did not believe it was their responsibility to ensure that only [approved] slides were being used, as they were not part of the approval process for the slide decks." *Id.* Ingram warned that "[t]his is a potentially serious matter and in the current environment, the chance of receiving Agency action, including but not limited to a Warning Letter, on this matter is in my opinion very high." *Id.*

F. The Board Approves The 2007–2011 Strategic Plan And Off–Label Botox Sales Continue To Grow.

After the Schim incident, the Board continued to authorize aggressive efforts to increase Botox sales. For example, the Board approved Allergan's 2007–2011 Strategic Plan, which explicitly linked the number of sales representatives, or Neuroscience Medical Consultants ("NMCs"), to increased off-label sales. Compl. ¶ 176 ***321** (noting that in "2006 [Allergan] Added 45 New NMCs & Spasticity grew 25%, and that in 2007, Allergan Added 19 New NMCs & Spasticity Est[imated] 18%" (alterations in original) (internal quotation omitted)). By February 2008, Allergan had nearly tripled the payroll for its Botox sales force relative to February 2003.

During the same period, the Board received detailed reports on Botox sales. For example, management presented the Board with a 2007 Customer Survey that showed U.S. Botox sales figures for on-label and off-label uses. By 2007, annual Botox sales for therapeutic uses totaled nearly $600 million, with 70–80% generated by off-label use.

G. The Government Settlement

On September 1, 2010, Allergan entered into a settlement with the United States Department of Justice. The settlement followed a three-year joint investigation of Allergan's off-label marketing practices by the Federal Bureau of Investigation, the FDA's Office of Criminal Investigation, and the Department of Health and Human Services, Office of Inspector General. Under the terms of the settlement, Allergan agreed to plead guilty to criminal misdemeanor misbranding for the period from 2000 through 2005 and pay criminal fines of $375 million. Allergan also agreed to pay an additional $225 million in civil fines to resolve False

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Claims Act lawsuits which alleged similar off-label marketing claims. The $600 million penalty equaled 96% of the company's reported net income in 2009 and exceeded both its 2007 and 2008 net income.

As part of the settlement, Allergan entered into a five-year Corporate Integrity Agreement with the Department of Health and Human Services, Office of Inspector General. The agreement mandates that Allergan implement a strict compliance program, notify physicians of the government settlement, and post information on payments to physicians on the company's website.

H. The Derivative Actions

The public announcement of the settlement on September 1, 2010, prompted plaintiffs' firms who specialize in stockholder representative litigation to rush to the courthouse. For reasons described below, this unfortunate behavior reflects understandable choices made by these rational economic actors given the incentives currently created by our legal system. *See infra* Part II.A.3.

On September 3, 2010, Louisiana Municipal Police Employees' Retirement System ("LAMPERS") filed this action. The original complaint relied solely on the Allergan press release and other publicly available information. Given the short time frame involved, counsel had minimal opportunity to investigate the claims. Nor could counsel have evaluated meaningfully whether or not a sufficient number of Allergan directors were disabled such that the Board was not the appropriate corporate actor to address the fallout from the government investigation.

Between September 9 and 24, 2010, other specialized stockholder plaintiffs' firms filed similar derivative actions in the California Federal Court. *See Rosenbloom v. Pyott,* No. SACV10–01352–DOC; *Himmel v. Pyott,* No. SACV10–01417–JVS; *Pompano Beach Police & Firefighters' Ret. Sys. v. Pyott,* No. SACV10–01449–DOC. On October 25, the California Federal Court consolidated the cases. *See In re Allergan Inc. S'holder Deriv. Litig.,* Case No. SACV10–01352–DOC, 2011 WL 1429626. One stockholder plaintiffs' firm sent Allergan a litigation demand. *See* Dkt. 19, Ex. D.

***322** On October 11, 2010, LAMPERS filed its first amended complaint in this action. The amended complaint contained additional detail drawn from publicly available materials. The principal sources were the False Claims Act complaints filed against Allergan in 2007, 2008, and 2009, a sentencing memorandum filed by the Department of Justice on October 4, 2010, in support of its settlement and plea agreement with Allergan, and the plea agreement itself, which was filed on October 5. The amended complaint cribbed from these documents. Allergan and the defendant directors moved to dismiss the amended complaint pursuant to Rules 23.1 and 12(b)(6).

On November 3, 2010, UFCW sent Allergan a Section 220 demand for books and records. On November 30, UFCW moved to intervene in this action. LAMPERS joined the defendants in vehemently opposing the motion to intervene. Rather than welcoming UFCW as a litigation partner and potential source of information to craft an even better complaint, LAMPERS attacked UFCW in an effort to maintain control over the case. LAMPERS' opposition maligned UFCW's efforts as "indefensible" and "serv[ing] only to unduly delay the adjudication of the rights of the original parties, while providing absolutely no benefit to Allergan, Inc." Dkt. 37, Opp'n Mem. 1–2. In doing so, LAMPERS seemed oblivious to the Delaware courts' repeated exhortations that plaintiffs use Section 220 before filing derivative actions, as UFCW was doing, or that defendants regularly prevail when moving to dismiss hastily filed derivative complaints prepared without the benefit of books and records. *See infra* Part II.A.3.

On January 21, 2011, I denied the motion to intervene without prejudice as prematurely filed, but postponed any hearing on the motions to dismiss "until after the 220 process is over." *La. Mun. Police Empls. Ret.*

Sys. v. Pyott, C.A. No. 5795–VCL, at 56–57, 2011 WL 283303 (Del.Ch. Jan. 21, 2011) (TRANSCRIPT). LAMPERS and UFCW then reached an accommodation permitting both to serve as co-plaintiffs. After pressing forward with its Section 220 demand, UFCW eventually obtained documents. The Delaware plaintiffs jointly filed the Complaint on July 8. The defendants moved to dismiss on July 15.

Meanwhile, in the California Action, the California Federal Court dismissed the plaintiffs' first complaint without prejudice on April 12, 2011. The California plaintiffs asked Allergan for the Section 220 production, and Allergan shared it. The California plaintiffs subsequently filed an amended complaint that incorporated the documents Allergan provided, and the California defendants again moved to dismiss.

For reasons that are not clear to me, briefing on the motions to dismiss moved forward more quickly in California than in Delaware. On January 17, 2012, without the benefit of oral argument, the California Federal Court issued the California Judgment, a five-page order dismissing the California Action with prejudice pursuant to Rule 23.1 for failure to plead demand futility. On February 22, the California Federal Court denied a motion for reargument. The defendants then supplemented their motions to dismiss in this action to invoke collateral estoppel.

II. LEGAL ANALYSIS

The defendants identify three bases on which they say judgment should be entered in their favor: collateral estoppel, Rule 23.1, and Rule 12(b)(6). If collateral estoppel applies, then I need not consider the others, so I start there.

***323** A growing body of precedent holds that a Rule 23.1 dismissal has preclusive effect on other derivative complaints. [1] These cases reason that because a stockholder plaintiff in a derivative action sues in the name of the corporation, all other stockholder plaintiffs are in privity with the plaintiff in the dismissed derivative action. In my view, the answer to the privity question turns on the legal relationship between a stockholder and the corporation, which is governed by Delaware law under the internal affairs doctrine.

Controlling Delaware Supreme Court precedent makes clear that until a Rule 23.1 motion has been *denied,* a derivative plaintiff whose litigation efforts are opposed by the corporation does *not* have authority to sue in the name of the corporation. Consequently, at the time of the first Rule 23.1 dismissal, other stockholders are not in privity with the stockholder plaintiff in the first derivative action, and a decision *granting* a Rule 23.1 dismissal cannot have preclusive effect. The dismissal remains persuasive authority, but it is not preclusive.

The defendants rely on *LeBoyer,* a California collateral estoppel decision that conflicts with controlling Delaware Supreme Court authority on the effect of a Rule 23.1 dismissal. If the collateral estoppel issue were properly presented to the California Federal Court, that court should decline to follow *LeBoyer* and hold instead that collateral estoppel does not bar a later derivative action by a different stockholder.

Because the California Judgment does not have preclusive effect, I analyze the defendants' motions to dismiss pursuant to Rules 23.1 and 12(b)(6). Respectfully disagreeing with the California Federal Court, I deny the Rule 23.1 motion. With all reasonable inferences drawn in favor of the plaintiffs, as required at this procedural stage, the Complaint's particularized allegations raise a reasonable doubt that a majority of the Board could properly consider a demand. Read as a whole, the particularized allegations support a reasonable inference that the Board consciously approved a business plan predicated on violating the federal statutory prohibition against off-label marketing. “[O]ne cannot act loyally as a corporate director by causing the corporation to violate the positive laws it is obliged to obey.” *Guttman v. Huang,* 823 A.2d

492, 506 n. 34 (Del.Ch.2003). "[I]t is generally accepted that a derivative suit may be asserted by an innocent stockholder on behalf of a corporation against corporate fiduciaries who knowingly caused the corporation to commit illegal acts and, as a result, caused the corporation to suffer harm." *In re Am. Int'l Gp., Inc., Consol. Deriv. Litig.,* 976 A.2d 872, 889 (Del.Ch.2009). The Complaint therefore pleads a non-exculpated breach of the duty of loyalty, exposes the defendants to a substantial threat of liability, and renders demand futile.

Determining that the Complaint alleges particularized facts that present a substantial threat of liability under the heightened Rule 23.1 pleading standard necessarily determines that the Complaint states a ***324** claim under the more plaintiff-friendly Rule 12(b)(6) standard. That motion is therefore denied as well.

A. Collateral Estoppel

The defendants observe that in *LeBoyer,* the California Federal Court applied collateral estoppel to hold that a California state court's dismissal with prejudice of one stockholder plaintiff's derivative action pursuant to Rule 23.1 barred a different stockholder plaintiff from suing derivatively. The defendants correctly point out that when applying collateral estoppel, this Court must give a judgment the same force and effect that it would be given by the rendering court. [2] Having obtained the California Judgment, they say I must follow *LeBoyer.* I disagree.

LeBoyer described collateral estoppel as having five elements:

> First, the issue sought to be precluded from relitigation must be identical to that decided in a former proceeding. Second, this issue must have been actually litigated in the former proceeding. Third, it must have been necessarily decided in the former proceeding. Fourth, the decision in the former proceeding must be final and on the merits. Finally, the party against whom preclusion is sought must be the same as, or in privity with, the party to the former proceeding.

2007 WL 4287646, at *1 (quoting *In re Cantrell,* 329 F.3d 1119, 1123 (9th Cir.2003)). In substance, *LeBoyer* 's five-part test matches shorter formulations that the California Federal Court might apply. *See, e.g., Hydranautics v. FilmTec Corp.,* 204 F.3d 880, 885 (9th Cir.2000) ("Under both California and federal law, collateral estoppel applies only where it is established that '(1) the issue necessarily decided at the previous proceeding is identical to the one which is sought to be re-litigated; (2) the first proceeding ended with a final judgment on the merits; and (3) the party against whom collateral estoppel is asserted was a party or in privity with a party at the first proceeding.' " (quoting *Younan v. Caruso,* 51 Cal.App.4th 401, 59 Cal.Rptr.2d 103, 106 (1996))).

For purposes of this case, I need only consider privity. I need not contemplate whether a Rule 23.1 dismissal is "on the merits" for purposes of collateral estoppel. [3] Neither must I address the level of ***325** specificity at which the "same issue" analysis operates, [4] nor ponder whether the analysis should be limited to information actually known to and alleged by the initial derivative plaintiff versus extending to information that could have been known to and alleged by the initial derivative plaintiff but were not. [5] Because the defendants only invoke collateral estoppel (*i.e.,* issue preclusion), I will not consider the more expansive doctrine of *res judicata* (*i.e.,* claim preclusion). [6]

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1. Choice of Law

[1] [2] [3] Whether successive stockholders are sufficiently in privity with the corporation and each other is a matter of substantive Delaware law governed by the internal affairs doctrine. *See Sonus Networks,* 499 F.3d at 64. "No principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations...." *CTS Corp. v. Dynamics Corp. of Am.,* 481 U.S. 69, 89, 107 S.Ct. 1637, 95 L.Ed.2d 67 (1987). "Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation." *Cort v. Ash,* 422 U.S. 66, 84, 95 S.Ct. 2080, 45 L.Ed.2d 26 (1975). "The internal affairs doctrine is a conflict of laws principle which recognizes that only one State should have the authority to regulate a corporation's internal affairs—matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders...." *Edgar v. MITE Corp.,* 457 U.S. 624, 645, 102 S.Ct. 2629, 73 L.Ed.2d 269 (1982); *accord* ***326** *VantagePoint Venture P'rs 1996 v. Examen, Inc.,* 871 A.2d 1108, 1113 (Del.2005) (explaining that "matters that pertain to the relationships among or between the corporation and its officers, directors, and shareholders" fall within the internal affairs doctrine); *see* Restatement (Second) of Conflict of Laws § 304 (1971) [hereinafter Conflict of Laws] (concluding that the law of state of incorporation generally should "determine the right of a shareholder to participate in the administration of the affairs of the corporation").

The United States Supreme Court has held that "the function of the demand doctrine in delimiting the respective powers of the individual shareholder and of the directors to control corporate litigation clearly is a matter of 'substance,' not 'procedure,' " and is therefore governed by the internal affairs doctrine. *Kamen v. Kemper Fin. Servs., Inc.,* 500 U.S. 90, 96–97, 111 S.Ct. 1711, 114 L.Ed.2d 152 (1991); *accord Braddock v. Zimmerman,* 906 A.2d 776, 784 (Del.2006) ("The demand requirement of Rule 23.1 is a substantive right ...." (internal quotation omitted)); *Ainscow v. Sanitary Co. of Am.,* 180 A. 614, 615 (Del.Ch.1935) (Wolcott, Jos., C.) ("The question of whether a stockholder may act as a volunteer in taking up the cudgels in behalf of his corporation ... is one of his right and authority to act."). Whether a stockholder in a Delaware corporation can sue derivatively after another stockholder attempted to plead demand futility raises a question of demand futility law. In *Kamen,* the United States Supreme Court held that applying a universal-demand rule in federal court would disrupt the internal affairs of corporations and cautioned "against establishing competing federal—and state—law principles on the allocation of managerial prerogatives within [a] corporation." *Kamen,* 500 U.S. at 106, 111 S.Ct. 1711 (citing *Burks v. Lasker,* 441 U.S. 471, 99 S.Ct. 1831, 60 L.Ed.2d 404 (1979)). In my view, whether a stockholder can sue derivatively after another stockholder attempted to plead demand futility is equally a matter involving the managerial prerogatives within a corporation. It is therefore a matter controlled by the internal affairs doctrine and governed by the law of the state of incorporation. *See id.* at 108–09, 111 S.Ct. 1711 ("[A] court that is entertaining a derivative action ... must apply the demand futility exception as it is defined by the law of the State of incorporation."); *VantagePoint,* 871 A.2d at 1115 (following *Kamen*).

[4] As in *Kamen,* applying the internal affairs doctrine in this setting promotes the important objective of treating directors, officers, and stockholders uniformly across jurisdictions. *See* Conflict of Laws § 302, cmt. e ("Uniform treatment of directors, officers and shareholders is an important objective which can only be attained by having the rights and liabilities of those persons with respect to the corporation governed by a single law.").

> Large corporations that are listed on national exchanges, or even regional exchanges, will have shareholders in many States and shares that are traded frequently. The markets that facilitate this national and international participation in ownership of corporations are essential for providing capital not only for new enterprises but also for established companies that need to expand their businesses. This beneficial

> free market system depends at its core upon the fact that a corporation—except in the rarest situations —is organized under, and governed by, the law of a single jurisdiction, traditionally the corporate law of the State of its incorporation.
>
> ....
>
> It thus is an accepted part of the business landscape in this country for States to create corporations, to prescribe their powers, and to define the ***327** rights that are acquired by purchasing their shares. A State has an interest in promoting stable relationships among parties involved in the corporations it charters, as well as in ensuring that investors in such corporations have an effective voice in corporate affairs.

CTS Corp., 481 U.S. at 90–91, 107 S.Ct. 1637. To my mind, whether a stockholder in a Delaware corporation can sue derivatively after another stockholder attempted to plead demand futility should not be governed by potentially different rules across twelve federal circuits, fifty states, and the District of Columbia, Puerto Rico, and other territories. Applying different rules in different courts would disrupt the internal affairs of corporations. *See Kamen,* 500 U.S. at 106, 111 S.Ct. 1711. Whether a stockholder in a Delaware corporation can sue derivatively after another stockholder attempted to plead demand futility should be governed uniformly by Delaware law.

2. The Same Party Or A Party In Privity

[5] In determining that successive stockholders were in privity for purposes giving collateral estoppel effect to a Rule 23.1 dismissal, *LeBoyer* relied on the legal truism that a derivative plaintiff sues in the name of the corporation. In the court's words, "the fifth element is satisfied in that in both suits the plaintiff is the corporation itself. The differing groups of shareholders who can potentially stand in the corporation's stead are in privity for the purposes of issue preclusion." 2007 WL 4287646, at *3. Other decisions giving preclusive effect to Rule 23.1 dismissals have reasoned similarly. [7] For example in *Sonus Networks,* the leading federal decision on Rule 23.1 preclusion, the United States Court of Appeals for the First Circuit stated:

> It is a matter of black-letter law that the plaintiff in a derivative suit represents the corporation, which is the real party in interest. Under Massachusetts law, a derivative suit is prosecuted in the right of the corporation. Standing to represent a foreign corporation is governed by the laws of the state of incorporation, and Delaware law is in accord with the prevailing rule that the shareholder in a derivative suit represents the corporation.
>
> 499 F.3d at 63–64 (citations and internal quotation omitted).

[6] These cases miss that as a matter of Delaware law, a stockholder whose litigation efforts are opposed by the corporation does not have authority to sue on behalf of the corporation until there has ***328** been a finding of demand excusal or wrongful refusal. In *Rales v. Blasband,* the Delaware Supreme Court addressed this issue:

> Because directors are empowered to manage, or direct the management of, the business and affairs of the corporation, the right of a stockholder to prosecute a derivative suit is limited to situations where the stockholder has demanded that the directors pursue the corporate claim *and* they have wrongfully refused to do so *or* where demand is excused because the directors are incapable of making an impartial decision regarding such litigation.

634 A.2d 927, 932 (Del.1993) (emphases added; citation omitted). In *Kaplan v. Peat, Marwick, Mitchell & Co.,* the Delaware Supreme Court was equally clear:

> [P]re-suit demand under Chancery Court Rule 23.1 is an objective burden which must be met in order for the shareholder to have capacity to sue on behalf of the corporation. *The right to bring a derivative action does not come into existence until the plaintiff shareholder has made a demand on the corporation to institute such an action or until the shareholder has demonstrated that demand would be futile.*

540 A.2d 726, 730 (Del.1988) (emphasis added). Delaware Court of Chancery decisions have long expressed these same principles. *See, e.g., Ainscow,* 180 A. at 615 ("[A] stockholder has no right to file a bill in the corporation's behalf unless he has first made demand on the corporation that it bring the suit and the demand has been answered by a refusal, or unless the circumstances are such that because of the relation of the responsible officers of the corporation to the alleged wrongs, a demand would be obviously futile ...."); *accord Maldonado v. Flynn,* 413 A.2d 1251, 1262 (Del.Ch.1980) ("The stockholder's individual right to bring the action does not ripen, however, until he has made a demand on the corporation which has been met with a refusal by the corporation to assert its cause of action or unless he can show a demand to be futile."), *rev'd on other grounds, Zapata Corp. v. Maldonado,* 430 A.2d 779, 784 (Del.1981) ("[W]here demand is properly excused, the stockholder does possess the ability to initiate the action on his corporation's behalf.").

[7] The derivative plaintiff's lack of authority to sue on behalf of the corporation until the denial of a Rule 23.1 motion likewise flows from the two-fold nature of the derivative suit. As the Delaware Supreme Court explained in *Aronson v. Lewis,* the seminal demand-futility decision, "[t]he nature of the [derivative] action is two-fold. First, it is the equivalent of a suit by the shareholders to compel the corporation to sue. Second, it is a suit by the corporation, asserted by the shareholders on its behalf, against those liable to it." 473 A.2d 805, 811 (Del.1984). [8] Later Delaware ***329** Supreme Court decisions repeatedly reaffirmed the two-fold nature of the derivative suit. [9] Nor was this a new concept. Half a century before *Aronson,* Chancellor Josiah Wolcott wrote:

> The complainants' case, being asserted by them in their derivative right as stockholders, has a double aspect. Its nature is dual. It asserts as the principal cause of action a claim belonging to the corporation to have an accounting from the defendants and a decree against them for payment to the corporation of the sum found due on such accounting. In this aspect, the cause of action is the corporation's. It does not belong to the complainants. Inasmuch however as the corporation will not sue because of the domination over it by the alleged wrongdoers who are its directors, the complainants as stockholders have a right in equity to compel the assertion of the corporation's rights to redress. This is their individual right. A bill filed by stockholders in their derivative right therefore has two phases—one is the equivalent of a suit to compel the corporation to sue, and the other is the suit by the corporation, asserted by the stockholders in its behalf, against those liable to it. The former belongs to the complaining stockholders; the latter to the corporation.
>
> *Cantor v. Sachs,* 162 A. 73, 76 (Del.Ch.1932) (citations omitted); *accord Harff v. Kerkorian,* 324 A.2d 215, 218 (Del.Ch.1974) ("The nature of the derivative suit is two-fold: first, it is the equivalent of a suit by the stockholders to compel the corporation to sue; and second, it is a suit by the corporation, asserted by the stockholders in its behalf, against those liable to it."), *aff'd in part, rev'd in part on other grounds,* 347 A.2d 133 (Del.1975). The granting of a Rule 23.1 motion does not address claims brought in the name

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of the corporation. It addresses only the first phase of the derivative action in which the stockholder sues individually.

Under these controlling Delaware precedents, until the derivative action passes the Rule 23.1 stage, the stockholder does not have authority to assert the corporation's claims and is not suing in the name of the corporation. Until a Rule 23.1 motion is denied or the board decides not to oppose the derivative action, the stockholder plaintiff is only suing to "compel the corporation to sue." *Aronson,* 473 A.2d at 811. Put differently, the stockholder is asking the Court for authority to sue in the name of the corporation. Indeed, where a court *grants* a Rule 23.1 motion, the fact that the suing stockholder lacks authority to sue in the name of the corporation ***330** and assert corporate claims should be clear. That is precisely what granting a Rule 23.1 motion means. This fact in turn exposes the inequity of defendants subsequently arguing for preclusive effect. Having first argued in their Rule 23.1 motion that the stockholder plaintiff lacks authority to assert claims derivatively on behalf of the corporation—*and having prevailed on that point*—the same defendants next argue that the stockholder nevertheless had authority to assert the claims on behalf of the corporation sufficient to bind all other stockholders. Judicial estoppel should bar such a reversal of position. [10]

In my view, therefore, the legal truism that the underlying claim in a derivative action belongs to the corporation and ultimately will be asserted in the corporation's name if the stockholder plaintiff receives permission to sue does not support the proposition that stockholders are in privity for purposes of the preclusive effect of an order granting a Rule 23.1 motion. At that phase of the case, the competing stockholders are asserting only their individual claim to obtain equitable authority to sue. *See Aronson,* 473 A.2d at 811; *Cantor,* 162 A. at 76.

Courts giving preclusive effect to Rule 23.1 dismissals also have relied on generally accurate statements to the effect that a judgment in an action brought by or on behalf of the corporation binds all stockholders. For example, in *Henik,* a decision often cited as authority for giving preclusive effect to a Rule 23.1 dismissal, the court quoted a 1942 decision for the proposition that " '[a] judgment in the stockholders' derivative action is res judicata both as to the corporation and as to all of its stockholders, including stockholders who were not parties to the original action in subsequent actions based upon the same subject matter.' " 433 F.Supp.2d at 380 (quoting *Ratner v. Paramount Pictures, Inc.,* 6 F.R.D. 618, 619 (S.D.N.Y.1942)). [11]

***331** This statement of black letter law certainly holds true when the plaintiff has authority to assert the corporation's claims. It holds, for example, when (i) the corporation has brought the case or taken it over through the special litigation committee process, (ii) the derivative plaintiff has survived a Rule 23.1 motion, thereby gained authority to sue, and obtained a decision on summary judgment or at trial, or (iii) a court has approved a derivative action settlement and made the determinations required by Rule 23.1. The statement does not hold true when the stockholder plaintiff lacks authority to sue on behalf of the corporation, and it particularly does not hold true for a decision determining that the stockholder plaintiff lacks authority to sue.

This Court has held squarely that the adjudication of one stockholder's individual claim does not have preclusive affect on a second stockholder's ability to assert the claim. *Kohls v. Kenetech Corp.,* 791 A.2d 763 (Del.Ch.2000), *aff'd,* 794 A.2d 1160 (Del.2002). In *Kohls,* preferred stockholders filed suit to enforce their claimed entitlement to a preferential distribution on their securities. *Id.* at 766. Certain other non-party preferred stockholders previously had brought an individual action requesting similar relief that resulted in a post-trial judgment for the defendants. *Id.* at 767, 768 n. 18. The defendants argued that under the doctrines of *res judicata* and collateral estoppel, the prior judgment barred the later stockholders from relitigating the claim to a preferential distribution. *Id.* at 767. This Court rejected the defendants' preclusion arguments, *id.* at 770, and the Delaware Supreme Court affirmed, *Kohls v. Kenetech Corp.,* 794 A.2d 1160 (Del.2002) (ORDER).

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The Court of Chancery in *Kohls* started from the foundational principle that "[a] person who is not a party to an action is not bound by the judgment in that action." 791 A.2d at 769 (quoting Restatement (Second) of Judgments § 62 cmt. c (1982) [hereinafter Judgments]). This "basic principle of law" is subject to three exceptions. Judgments § 62 cmt. a. One applies "where a non-party has a *specific type of pre-existing legal relationship with a named party,* such as bailor and bailee, predecessor and successor or indemnitor and indemnitee." *Kohls,* 791 A.2d at 769. "Being fellow stockholders is plainly not the type of legal relationship that fits [this] exception.... An individual stockholder is not, solely because of potentially aligned interests, presumed to act in the place of (and with the power to bind) the other stockholders." *Id.*

A second exception applies when "a person who is not a party to an action ... is involved with it in a way that falls short of becoming a party but which justly should result in his being denied opportunity to relitigate the matters previously in issue." Judgments § 62 cmt. a. "Several kinds of conduct by a non-party are recognized as having this effect. These include allowing the use of one's name as a party when the effect is to mislead an opposing litigant; assuming control of litigation being maintained by another; and agreeing to be bound by an adjudication between others." *Id.* (citations omitted). Concrete, case-specific actions by a stockholder plaintiff or its counsel might well trigger this exception, such as, for example, if the same counsel represented both stockholders or ***332** the plaintiffs otherwise collaborated. This Court's Section 220 jurisprudence has developed similar principles for determining when one stockholder's efforts to use Section 220 should be limited by a different stockholder's filing of a federal securities action that triggered the automatic stay under the Private Securities Litigation Reform Act (the "PLSRA"). *See, e.g., Beiser v. PMC–Sierra, Inc.,* 2009 WL 483321, at *3 (Del.Ch. Feb. 26, 2009); *Cohen v. El Paso Corp.,* 2004 WL 2340046, at *2 (Del.Ch. Oct. 18, 2004). But the general scenario of parallel, overlapping, or *seriatim* efforts by unaffiliated stockholders to assert or prompt the assertion of corporate claims does not implicate this exception.

This leaves the third and most pertinent exception: a properly commenced and maintained representative action. *Kohls,* 791 A.2d at 769. Stockholder class and derivative actions clearly qualify, but even here, the authority to represent others is not conferred automatically by filing of complaint. "A representative party must be granted ... authority, either by the represented party itself (in accordance with agency principles) or, in the class action context, by the court." *Id.* It is "self-evident that if a litigant never seeks to and is never compelled to act in a representative capacity, the class of people that *theoretically could have been* represented by that litigant is in no way precluded from asserting their own claims in a subsequent proceeding." *Id.* at 769–70. *See* Judgments § 41 (identifying categories of persons who can bind non-parties as including "[t]he representative of a class of persons similarly situated, *designated as such with the approval of the court,* of which the person is a member" (emphasis added)); *id.* § 59 cmt. c ("The stockholder's or member's derivative action is usually though not invariably in the form of a suit by some of the stockholders or members as representatives of all of them. Whether the judgment in such a representative suit is binding upon all stockholders or members is determined by the rules stated in §§ 41 and 42.").

Despite determining that neither *res judicata* nor collateral estoppel applied, the *Kohls* Court nevertheless dismissed the second lawsuit as a matter of *stare decisis:* "[B]ecause the [plaintiffs] fail to distinguish their claims, either factually or legally, from those adjudicated" in the prior action, "[n]ormal respect for the principle of *stare decisis* " required dismissal under Rule 12(b)(6). 791 A.2d at 770. "[A]lthough plaintiffs are not literally bound by the [underlying judgment], they must still state a viable cause of action." *Id.* In other words, the prior judgment was not preclusive, but it still could be persuasive and compel dismissal.

When a stockholder representative pursues claims on a class basis, authority is conferred by the Court's class certification ruling. *See* Ct. Ch. R. 23; *Schwarzschild v. Tse,* 69 F.3d 293, 297 (9th Cir.1995) ("[W]hen defendants obtain summary judgment before the class has been properly certified or before notice has been

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sent, ... [the summary judgment] decision binds only the named plaintiffs."); 3 Alba Conte & Herbert B. Newberg, *Newberg on Class Actions* § 7.15, at 52 (4th ed. 2002) ("[I]f a motion to dismiss or for summary judgment is granted in favor of the defendants" prior to class certification, "the resulting order would not be binding on the class which would not suffer prejudice."). When a stockholder representative pursues claims in a derivative action, authority can be conferred in two ways. First, the board of directors or a duly empowered committee can approve the litigation expressly or by failing to oppose it. *See Peat, Marwick,* 540 A.2d at 730. Second, and more commonly, a court can determine that the stockholder plaintiff has authority ***333** to proceed by denying a Rule 23.1 motion because the complaint adequately pleads either that demand should be excused as futile or that demand was made and wrongfully refused.

When the *same* stockholder responds to a Rule 23.1 dismissal by attempting to file a second complaint alleging demand futility, the "same party" requirement is met and a Rule 23.1 dismissal may have preclusive effect. *See W. Coast Mgmt.,* 914 A.2d at 641–44 (holding that collateral estoppel bars "the same plaintiff" from filing a subsequent derivative suit); *see also Meng v. Schwartz,* 305 F.Supp.2d 49, 60 (D.D.C.2004) (applying collateral estoppel to bar same derivative plaintiffs' efforts to relitigate previously dismissed claims); *Treeby v. Aymond,* 2000 WL 869502, at *8 (E.D.La. June 28, 2000) (issuing injunction against state court derivative action where same stockholder sought to relitigate demand excusal), *aff'd,* 251 F.3d 156 (5th Cir.2001). The same stockholder therefore cannot attempt to plead demand futility, lose, and then try again. This is also true as a matter of demand futility law. In ***Grimes***, the Delaware Supreme Court held that if a stockholder files a complaint alleging that demand should be excused as futile and the complaint is dismissed pursuant to Rule 23.1, that same stockholder cannot try again with a different set of demand futility allegations. 673 A.2d 1207, 1218–19. That the Delaware Supreme Court rendered its decision without mentioning collateral estoppel or *res judicata* suggests that the high court did not envision an expansive (if any) role for preclusion doctrine in the Rule 23.1 context. [12]

Consequently, when a different stockholder attempts to plead demand excusal, an earlier Rule 23.1 dismissal should not have preclusive effect. The earlier dismissal terminated the first phase of the prior derivative action, in which the complaining stockholder asserted an individual claim to seek equitable authority to sue on behalf of the corporation. Under *Kohls,* the prior ruling does not affect the individual claims of other stockholders to seek equitable authority to sue. It similarly has no effect on the second-phase issue of the corporation's cause of action. The decision does, of course, carry persuasive weight and can operate as *stare decisis.*

The Court of Chancery traditionally has recognized these principles. "It is common practice in this court where there are inadequate allegations of demand futility to dismiss derivative suits as to the named plaintiff, but not as to the corporation or its other stockholders." *W. Coast Mgmt.,* 914 A.2d at 642. Effective June 1, 2001, the Court of Chancery adopted Rule ***334** 15(aaa), which limits a plaintiff's ability to file *seriatim* amended complaints. It provides:

> [A] party that wishes to respond to a motion to dismiss under Rules 12(b)(6) or 23.1 by amending its pleading must file an amended complaint, or a motion to amend in conformity with this Rule, no later than the time such party's answering brief in response to either of the foregoing motions is due to be filed. In the event a party fails to timely file an amended complaint or motion to amend under this subsection (aaa) and the Court thereafter concludes that the complaint should be dismissed under Rule 12(b)(6) or 23.1, such dismissal shall be with prejudice (*and in the case of complaints brought pursuant to Rules 23 or 23.1 with prejudice to the named plaintiffs only*) unless the Court, for good cause shown, shall find that dismissal with prejudice would not

> be just under all the circumstances. Rules 41(a), 23(e) and 23.1 shall be construed so as to give effect to this subsection (aaa).

Ct. Ch. R. 15(aaa) (emphasis added). The language of Rule 15(aaa) confirms that a dismissal pursuant to Rule 23.1 is "with prejudice to the named plaintiffs only." *Id.*

This Court took a different approach in *Career Education,* a decision with which I respectfully disagree. *Career Education* followed the federal cases holding that a Rule 23.1 dismissal has broad preclusive effect. [13] It summarized those decisions as follows:

> [A] trend in recent federal case law extend[s] collateral estoppel to different plaintiffs in a second derivative suit. Those cases justified the extension of [estoppel] doctrine based on the unique position of the parties in derivative suits. Because the corporation is the true party in interest in a derivative suit, courts have precluded different derivative plaintiffs in subsequent suits. This commonality lends itself to the application of collateral estoppel or issue preclusion.
>
> 2007 WL 2875203, at *10 (footnotes omitted). The *Career Education* decision thus assumed, as did the federal cases, that privity exists for purposes of a Rule 23.1 dismissal because "the corporation is the true party in interest in a derivative suit." *Id.* As discussed, controlling Delaware Supreme Court authority dictates a contrary conclusion at the Rule 23.1 stage. Notably, the plaintiffs in *Career Education* "concede[d] that collateral estoppel or issue preclusion applie[d] to their Rule 23.1 arguments" and contended only that they should not be precluded from raising issues not addressed in the prior action. *Id.* at *7. The *Career Education* Court therefore accepted that a Rule 23.1 dismissal would have preclusive effect, did not grapple with the authority issue, and analyzed only whether (i) the plaintiffs in the prior proceeding provided adequate representation and (ii) the two cases involved different issues.

In my view, contrary to *Career Education,* an earlier Rule 23.1 dismissal does not have preclusive effect on a subsequent derivative action brought by a different plaintiff because, as the earlier Rule 23.1 decision itself established, the prior plaintiff lacked authority to sue on behalf of the corporation and therefore was not in privity with the corporation or other stockholders. ***335** This does not mean that the Rule 23.1 decision has no value or, as several courts have posited, that demand futility could be relitigated *ad infinitum.* [14] As *Kohls* makes clear, the earlier decision remains persuasive authority and could operate as *stare decisis.* When any other derivative plaintiff faces a Rule 23.1 motion involving the same transaction, the plaintiff must distinguish the new complaint or explain how the prior court erred such that the outcome of the motion would be different. I suspect that in many cases, the second court will follow the earlier ruling.

3. Inadequate Representation

[8] As an independent basis for declining to give collateral estoppel effect to the California Judgment, I find that the California plaintiffs did not adequately represent Allergan. The decisions that give preclusive effect to a Rule 23.1 dismissal universally recognize that another stockholder still can sue if the first plaintiff provided inadequate representation. [15]

Chancellor Strine has suggested Delaware law presume that a fast-filing stockholder with a nominal stake, who sues derivatively after the public announcement of a corporate trauma in an effort to shift the still-developing losses to the corporation's fiduciaries, but without first conducting a meaningful investigation, has not provided adequate representation. *See King v. VeriFone Hldgs., Inc.,* 994 A.2d 354, 364 n. 34 (Del.Ch.2010) ("*King I* "), *rev'd on other grounds,* 12 A.3d 1140 (Del.2011) ("*King II* ").

> When a derivative plaintiff files a damages action hastily in the wake of a public announcement, there is no basis for expediting the case to further the interests of the corporation and its stockholders, and, when the derivative plaintiff forewent a books and records investigation and a period of deep reflection on the publicly available documents and the law, should not the presumption be that the plaintiff is not fit to serve as the lead fiduciary for the corporation and its stockholders? What rational argument is there that it advances the legitimate interests of investors to give a ***336** leg up to the first to get to court in a situation when being first to court is likely to compromise the ability of the filing plaintiff to sustain his derivative complaint? Admittedly, there are no easy answers to the question of how to select lead counsel in representative actions, but what is certain is that rewarding plaintiffs and their counsel who sue first, and investigate and think second is likely to maximize the costs to investors of representative suits and minimize the benefits. Put simply, the speed racer approach might benefit certain interests, but those interests do not include the investors of corporations or the other societal constituencies dependent on the effective and efficient governance of corporations.

King I, 994 A.2d at 364 n. 34; *see Baca v. Insight Enters., Inc.,* 2010 WL 2219715, at *5 (Del.Ch. June 3, 2010) (questioning "whether a stockholder with a nominal stake who files an indemnification-based derivative action" quickly after the announcement of a corporate trauma "is adequately representing the interests of the corporation, as opposed to facilitating the pursuit of economic self-interest by an entrepreneurial law firm"). I adopt and apply the fast-filer presumption in this case.

a. The Fast–Filing Problem

Appreciating the need for the fast-filer presumption requires a big-picture understanding of the role derivative actions play in the corporate landscape. For publicly traded Delaware corporations, the enforcement of fiduciary obligations is largely carried out by specialized plaintiffs' firms who bring claims on a contingent basis. [16] Because diversified investors are rationally passive, specialized plaintiffs' firms play a critical role in the functioning of our legal system. As Chancellor Allen explained,

> [a] fundamental condition of the corporate form when stockholders are widely dispersed, as typically occurs in public corporations, is that individual shareholders have little incentive to bear the costs associated with activities that monitor board of director (or management) performance. Of course, a fundamental advantage that the corporate form offers to owners of capital is the utility that an investor gains through centralized management. Centralized management allows passive (low cost) ownership and promotes investor diversification. Limited liability and the entity status of a corporation similarly allow investors to be relatively passive. While the conditions that allow investors to be rationally passive are a primary source of utility, they can also lead to inefficiency to the extent centralized management may have incentives that are not perfectly aligned with those of the residual owners of the firm, which is inevitably the case. This imperfect alignment of incentives will inevitably lead to excess costs associated with centralized management. For that reason *some* expenditures ***337** for shareholder monitoring would be efficient. Such monitoring is, of course, more or less costly to the shareholder who engages in it. In a public company with widely distributed shares any particular shareholder has very little incentive

> to incur those costs himself in pursuit of a collective good, since unless there is some method to force a sharing of costs, he will bear all of the costs and only a (small) pro rata share of any gains that the monitoring yields.
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> *Bird v. Lida, Inc.,* 681 A.2d 399, 402–03 (Del.Ch.1996) (footnote omitted). Due to rational passivity, "it is likely that in a public corporation there will be less shareholder monitoring expenditures than would be optimum from the point of the shareholders as a collectivity." *Id.* at 403. Incentivized by contingent fees, specialized plaintiffs' firms can "pursue monitoring activities that are wealth increasing for the collectivity (the corporation or the body of its shareholders)." *Id.*

Because specialized plaintiffs' firms ultimately receive compensation from awards of attorneys' fees, their interests can diverge from the class or entity they represent. [17] Interests diverge routinely during the initial period following an event that could provide a basis for filing a case. *See Biondi,* 820 A.2d at 1158–59 (discussing representative counsel's interests when filing a derivative action); *see also Silverstein v. Warner Commc'ns, Inc.,* 1991 WL 12835, at *2–3 (Del.Ch. Feb. 5, 1991) (Allen, C.) (discussing similar interests of representative counsel in class action context).

A plaintiffs' firm only can obtain a fee if it first obtains a result. A firm cannot obtain a result if a competitor gains control of the case. Many jurisdictions are perceived to follow a "first-filed" rule that gives control within that jurisdiction to the first stockholder plaintiff and associated law firm to file a representative action. [18] ***338** Many jurisdictions likewise are perceived to give precedence to a "first-filed" action versus later-filed actions in other jurisdictions. [19] When an event occurs that could provide grounds for a representative action, the first-filed rule incentivizes plaintiffs' lawyers to file as fast as possible in an effort to gain control of the litigation. Motivated by first-to-file pressure, plaintiffs' firms rationally eschew conducting investigations and making books and records demands, fearing that any delay would enable competitors to gain control of the litigation and freeze-out the diligent lawyer. No role, no result, no fee.

The conflict arises because fast-filing imposes real costs on corporations and their stockholders. When fast-filed complaints follow the announcement of a transaction or other event that likely will require expedited litigation, they at least perform the beneficial function of identifying the firms who wish to compete for leadership status. In a quickly evolving deal setting, fast-filing enables a leadership structure to be put in place so that expedited litigation can begin in earnest. But in contexts that do not warrant expedition, any administrative benefit disappears. When plaintiffs sue derivatively to recover damages from directors and senior officers for harm suffered by the corporation, the hastily filed complaints have little chance of surviving a Rule 23.1 motion, yet the defendant fiduciaries must respond, and the corporation must underwrite the costs of defense, either directly through indemnification and advancement or indirectly through insurance.

b. The Idealized Derivative Action

When a corporation suffers harm, the board of directors is the institutional actor legally empowered under Delaware law to determine what, if any, remedial action the corporation should take, including pursuing litigation against the individuals involved. *See* 8 Del. C. § 141(a). "A cardinal precept of the General Corporation Law of the State of Delaware is that directors, rather than shareholders, manage the business and affairs of the corporation." *Aronson,* 473 A.2d at 811. "Directors of Delaware corporations derive their managerial decision making power, which encompasses decisions whether to initiate, or refrain from entering, litigation, from 8 *Del. C.* § 141(a)." *Zapata,* 430 A.2d at 782 (footnote omitted). ***339** Section 141(a) vests statutory authority in the board of directors to determine what action the corporation will take with its litigation assets, just as with other corporate assets. *See id.*

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Absent sufficient reason to doubt the directors' ability to make disinterested and independent decisions about litigation, the board is not only empowered but optimally positioned to make decisions on behalf of the corporation and, if appropriate, pursue litigation. The board can deploy the corporation's resources to investigate the wrongdoing and seek a remedy. The directors have full access to the corporation's internal information, including privileged communications. The board can seek cooperation from management and employees and utilize the company's internal expertise. In contrast to the Court, which typically only can award some form of damages, the board can bargain with alleged wrongdoers and craft remedies that may better serve the entity. Perhaps most significantly, the board can take into consideration and balance the interests of multiple constituencies when determining what outcome best serves the interests of stockholders. *See, e.g.,* 1 R. Franklin Balotti & Jesse A. Finkelstein, *The Delaware Law of Corporations and Business Organizations* § 13.15, at 13–75 (3d ed.1998) (listing factors that special litigation committee should consider, including "[t]he magnitude and merits of the claims; [t]he size and likelihood of a recovery of damages or other relief; [t]he possible detriment to the company from the assertion of any claims, as well as the indirect costs, such as the effect upon other potential litigation to which the company is a party, and relationships with customers or suppliers; and [t]he remedial steps already taken and that, in the future, could be taken by the corporation to prevent a reoccurrence of the challenged actions"). Consequently, both as a matter of legal authority and optimal resource allocation, the "board of directors, unless legally disabled, should be presented with the opportunity to manage litigation that seeks to redress harm inflicted upon the corporation." *Saito v. McCall,* 2004 WL 3029876, *10 (Del.Ch. Dec. 20, 2004), *overruled on other grounds, Lambrecht v. O'Neal,* 3 A.3d 277 (Del.2010).

[9] In a derivative suit, a stockholder seeks to displace the board's authority. *Aronson,* 473 A.2d at 811; *see also Desimone v. Barrows,* 924 A.2d 908, 914 (Del.Ch.2007) (noting that issue for Rule 23.1 motion is "whether the ... board should be divested of its authority to address [the underlying] misconduct"). To do so, the complaint must allege with particularity that the board was presented with a demand and refused it wrongfully or that the board could not properly consider a demand, thereby excusing the effort to make demand as futile. Framed in the language of controlling Delaware Supreme Court precedent, demand is futile when "the particularized 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." [20]

***340** A breach of fiduciary duty claim that seeks to hold directors accountable for the consequences of a corporate trauma is known colloquially as a *Caremark* claim, in a tip of the judicial hat to Chancellor Allen's landmark decision. *See In re Caremark Int'l Inc. Deriv. Litig.,* 698 A.2d 959 (Del.Ch.1996). Because it is safe to say that non-sociopathic directors never consciously choose for the entity they oversee to suffer a disaster, a *Caremark* claim contends that the directors set in motion or "allowed a situation to develop and continue which exposed the corporation to enormous legal liability and that in doing so they violated a duty to be active monitors of corporate performance." *Id.* at 967. The list of corporate traumas for which stockholders theoretically could seek to hold directors accountable is long and ever expanding: regulatory sanctions, criminal or civil fines, environmental disasters, accounting restatements, misconduct by officers or employees, massive business losses, and innumerable other potential calamities.

[10] A stockholder cannot displace the board's authority simply by describing the calamity and alleging that it occurred on the directors' watch. " '[M]ost of the decisions that a corporation, acting through its human agents, makes are, of course, not the subject of director attention.' " *Stone ex rel. AmSouth Bancorporation v. Ritter,* 911 A.2d 362, 364, 372 (Del.2006) (quoting *Caremark,* 698 A.2d at 968). "[O]rdinary business decisions that are made by officers and employees deeper in the interior of the organization can ... vitally affect the welfare of the corporation and its ability to achieve its various strategic and financial goals."

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Caremark, 698 A.2d at 968. "[D]irectors' good faith exercise of oversight responsibility may not invariably prevent employees from violating criminal laws, or from causing the corporation to incur significant financial liability, or both...." *Stone,* 911 A.2d at 373. Without a connection to the board, a corporate calamity will not lead to director liability. Without a substantial threat of director liability, a court has no reason to doubt the board's ability to evaluate a demand.

[11] To plead a sufficient connection between the corporate trauma and the board, the plaintiff's first and most direct option is to allege with particularity actual board involvement in a decision that violated positive law. In *Caremark,* Chancellor Allen framed the test as whether the directors "knew or ... should have known" about illegality. *Caremark,* 698 A.2d at 971. In *Stone,* the Delaware Supreme ***341** Court tightened the test to require actual knowledge: "[I]mposition of liability requires a showing that the directors knew they were not discharging their fiduciary obligations." 911 A.2d at 370. Nevertheless, because sophisticated and well-advised individuals do not customarily confess knowing violations of law, a plaintiff following this route effectively must plead facts and circumstances sufficient for a court to infer that the directors knowingly violated positive law. *See In re Am. Int'l Gp., Inc., Consol. Deriv. Litig.,* 965 A.2d 763, 777, 795 (Del.Ch.2009).

[12] If the plaintiff cannot point to a decision, then the next alternative is to plead that the board consciously failed to act after learning about evidence of illegality—the proverbial "red flag." A plaintiff might plead, for example, that the directors

> ignored "red flags" indicating misconduct in defiance of their duties. A claim that an audit committee or board had notice of serious misconduct and simply failed to investigate, for example, would survive a motion to dismiss, even if the committee or board was well constituted and was otherwise functioning.

Shaev, 2006 WL 391931, at *5 (footnote omitted). A board that fails to act in the face of such information makes a conscious decision, and the decision not to act is just as much of a decision as a decision to act. *See Krieger v. Wesco Fin. Corp.,* 30 A.3d 54, 58 (Del.Ch.2011); *Hubbard v. Hollywood Park Realty Enters., Inc.,* 1991 WL 3151, at *10 (Del.Ch. Jan. 14, 1991). The decision to act and the conscious decision not to act are thus equally subject to review under traditional fiduciary duty principles and equally able to create the requisite connection to the board. *See Spiegel,* 571 A.2d at 773–74 ("[A] conscious decision by a board of directors to refrain from acting may be a valid exercise of business judgment...."); *Aronson,* 473 A.2d at 813 (equating "a conscious decision to refrain from acting" with a decision to act).

[13] If there is no evidence of direct board action or conscious inaction, then the plaintiff might seek to plead "that a board of directors is dominated or controlled by key members of management, who the rest of the board unknowingly allowed to engage in self-dealing transactions." *Shaev,* 2006 WL 391931, at *5 n. 11. Typically, however, the plaintiff must fall back to the final means of connecting the directors to illegality: the board's obligation to adopt internal information and reporting systems that are "reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance." [21] If a corporation suffers losses proximately caused by illegal conduct, and if the directors failed "to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists," then there is a sufficient connection between the occurrence of the illegal conduct and board level action or conscious inaction to support liability. *Caremark,* 698 A.2d at 970.

***342** **[14]** The burden on a plaintiff when seeking to establish liability under this final route "is quite high." *Id.* at 971.

> Generally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation, as in *Graham* [*v. Allis–Chalmers Manufacturing Company,* 188 A.2d 125 (Del.1963)] or in [the *Caremark* case itself], ... only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability.

Id. "Concretely, this latter allegation might take the form of facts that show the company entirely lacked an audit committee or other important supervisory structures, or that a formally constituted audit committee failed to meet." *Shaev,* 2006 WL 391931, at *5 (footnote omitted); *see Guttman,* 823 A.2d at 507 ("[T]he kind of fact pleading that is critical to a *Caremark* claim [is] ... contentions that the company lacked an audit committee, that the company had an audit committee that met only sporadically and devoted patently inadequate time to its work, or that the audit committee had clear notice of serious accounting irregularities and simply chose to ignore them or, even worse, to encourage their continuation."). As with the business judgment rule, this demanding standard benefits stockholders as a whole, because "it makes board service by qualified persons more likely, while continuing to act as stimulus to *good faith performance of duty* by such directors." *Caremark,* 698 A.2d at 971.

The standard for *Caremark* liability thus parallels the standard for imposing damages when a corporation has an exculpatory provision adopted pursuant to 8 *Del. C.* § 102(b)(7). *See Desimone,* 924 A.2d at 935. "Such a provision can exculpate directors from monetary liability for a breach of the duty of care, but not for conduct that is not in good faith or a breach of the duty of loyalty." *Stone,* 911 A.2d at 367.

> A failure to act in good faith may be shown, for instance, [1] where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, [2] where the fiduciary acts with the intent to violate applicable positive law, or [3] where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient.

In re Walt Disney Co. Deriv. Litig., 906 A.2d 27, 67 (Del.2006) (quoting *In re Walt Disney Co. Deriv. Litig.,* 907 A.2d 693, 755–56 (Del.Ch.2005), *aff'd,* 906 A.2d 27 (Del.2006)). A *Caremark* claim based on the failure to establish a monitoring system seeks to invoke the third of these examples. *See Stone,* 911 A.2d at 369 ("The third of [the *Disney*] examples describes, and is fully consistent with, the lack of good faith conduct that the *Caremark* court held was a 'necessary condition' for director oversight liability ...." (quoting *Caremark,* 698 A.2d at 971)). *See generally* Stephen M. Bainbridge et al., *The Convergence of Good Faith and Oversight,* 55 UCLA L.Rev. 559 (2008) (discussing the re-interpretation of *Caremark* as a good faith case and the potential liability risks to directors that result).

[15] Because a plaintiff must plead a connection to the board, only the extremely rare complaint will be able to establish the necessary linkage without referring to internal corporate documents. To obtain the necessary

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documents, the Delaware ***343** courts have long exhorted potential derivative plaintiffs to use Section 220 to investigate their claims and obtain corporate books and records *before* filing derivative litigation. [22] The Delaware courts have dismissed a steady stream of *Caremark* claims where the plaintiffs have not first used Section 220 to obtain books and records. [23] In bringing these actions, "plaintiffs ***344** seem to hope the Court will accept the conclusion that since the Company suffered large losses, and since a properly functioning risk management system would have avoided such losses, the directors must have breached their fiduciary duties in allowing such losses." *Citigroup,* 964 A.2d at 129. The Delaware courts consistently have rejected "such general ipse dixit syllogisms." *Id.* Not surprisingly, without first obtaining books and records, stockholders have not been able to link the trauma to the directors, and their *Caremark* complaints have been dismissed. [24] By contrast, stockholders who have used Section 220 and obtained documents showing board consideration or involvement have been able to survive Rule 23.1 motions. [25] Put simply, fast-filing generates dismissals.

If dispersed stockholders could act collectively following a corporate trauma, they would want the corporation to pursue claims vigorously against its fiduciaries only if there was a risk-adjusted prospect of a net-positive recovery. They would not file suit hastily, thereby imposing needlessly on themselves both the cost of their offensive litigation and the burdens of defense. The hypothetical stockholder collective would recognize there was no need to rush. The statute of limitations on a breach of fiduciary duty claim is three years. *In re Tyson Foods, Inc.,* 919 A.2d 563, 584 (Del.Ch.2007). If the underlying corporate trauma resulted from a government investigation, securities class action, or some other slowly unfurling event, there would likely be further developments that would yield additional information that could materially affect whether to sue. [26] This Court routinely stays indemnification-based derivative claims to allow the underlying action giving rise to potential ***345** liability to unfold. [27] Trustees who have been empowered to assert corporate claims regularly take their time, conduct thorough investigations, and may sue late in the statute of limitations period after they are well prepared. [28]

Rather than filing hastily, the hypothetical stockholder collective would proceed deliberately. It would hire well-qualified counsel. Through counsel, it would conduct an investigation and seek books and records using Section 220. After obtaining books and records, counsel would evaluate whether it made sense to sue. The books and records might show that the board had an appropriate monitoring system in place, but that the system did not alert the board. Or the books and records might show that despite their good faith efforts, the directors were misinformed or misled. Under these or other circumstances, the hypothetical stockholder collective logically might decide not to sue, preferring to leave their elected fiduciaries to the task of remedying the harm suffered by the corporation and dispensing with expensive litigation that likely would founder on Rule 23.1. If the stockholders had concerns, they might make a litigation demand, provide the board with the results of their ***346** investigation, and put the directors on notice. If the board declined to take action, the stockholders again could use Section 220 to investigate and consider a suit if the refusal was wrongful.

By contrast, if the books and records showed director misconduct, then the stockholders could decide to pursue a claim. Their counsel at that point would be well positioned to plead demand futility and survive a motion to dismiss. Importantly for all concerned, the costly process of briefing and arguing motions to dismiss would take place once, based on the stockholders' post-inspection complaint.

Under a first-to-file system, plaintiffs' lawyers cannot act as stockholders collectively would want because by proceeding deliberately, a law firm risks losing control of the case to competitors who file immediately. For fast-filing lawyers, the resulting action has the dynamics of a lottery ticket. In most cases, the fast-filing

plaintiff will not have pled a derivative claim that can overcome Rule 23.1. But in the rare case, fate may bless the fast-filer with something implicating the board, or a court might be offended by the magnitude of the corporate trauma and allow the derivative action to proceed. If the action survives a motion to dismiss, then its settlement value increases exponentially. *See* Kenneth B. Davis, Jr., *The Forgotten Derivative Suit,* 61 Vand. L.Rev. 387, 429–30 (2008) ("At least four of the eight [*Caremark*] cases where plaintiffs survived a motion to dismiss ultimately settled, all with significant attorneys' fees or monetary awards.... [T]he substantial corporate losses incurred in these cases increase the settlement value of a successful demand-excused claim.").

A fast-filer can readily build a portfolio of cases in the hope that one will hit. Filing a derivative claim is relatively cheap. Search costs are minimal because corporations publicly announce material adverse events. Public disclosures, news stories, and analyst reports provide the background information for the claim. *See id.* at 417 (finding empirical evidence "consistent with the critique that derivative suits simply piggyback on what the government (or perhaps even the media) already has uncovered and investigated"); John C. Coffee, Jr., *Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter Is Not Working,* 42 Md. L.Rev. 215, 221 n.15 (1983) (observing phenomenon of "piggybacking" by private plaintiffs' attorneys on efforts by government investigators to unearth wide range of classes of misconduct). Indeed, derivative plaintiffs often piggyback on the efforts of other specialized plaintiffs' firms by filing indemnification-based claims that crib from other complaints. *See, e.g., Guttman,* 823 A.2d at 504 (noting admission by plaintiffs' counsel that the complaints in federal securities class actions provided "the primary source of information" for the derivative complaint). As with a federal securities law claim, the lawyer's most difficult task typically will be finding a suitable plaintiff. [29]

***347** The first-to-file regime disserves stockholder interests across multiple dimensions. It prevents plaintiffs' lawyers from acting optimally. It forces defendants to respond to multiple complaints in multiple jurisdictions. It also confers significant litigation advantages on defendants. All else equal, defendants would vastly prefer to litigate against a plaintiff that has not used Section 220 or otherwise conducted a meaningful investigation. Witness the string of pleadings-stage dismissals in derivative actions filed after large corporate traumas. A state that ritualistically favored defendants might embrace such a regime, but Delaware has a long history of striving to balance the interests of stockholders and managers to craft an efficient corporation law. [30] "Representative litigation plays an important role in protecting the interests of stockholders, but it will not optimally serve investors unless suits are actually filed on the basis of a real concern that wrongdoing has occurred and after a proper investigation." *King I,* 994 A.2d at 356.

c. This Court's Efforts To Address Fast Filing

The fast-filer presumption suggested by Chancellor Strine comports with other steps this Court has taken to shape the legal incentives of specialized plaintiffs' firms. In addition to criticizing fast-filed, non-substantive complaints, this Court has made clear that when stockholder plaintiffs sue in a representative capacity, first-to-file does *not* control which plaintiff has the substantive right to proceed. [31] For claims implicating the internal affairs of Delaware corporations, this mitigates the first-to-file problem.

***348** This Court likewise has recognized the need to avoid a ritualistic first-to-file rule when representative plaintiffs compete across multiple jurisdictions. In *Biondi,* Chancellor Strine, then Vice Chancellor, considered whether to defer to a prior-filed Alabama case "initiated by a hastily-filed and cursorily pled complaint that barely alleged one of the claims raised by the Delaware plaintiffs as to only one of the

transactions raised by them." 820 A.2d at 1150. In declining to stay the Delaware actions in favor of prior-filed Alabama proceedings, Chancellor Strine recognized that

> representative actions pose certain dangers—in particular, the potential divergence in the best interests of the plaintiffs' attorneys and the plaintiffs they are purporting to represent—that are not addressed, and indeed may be exacerbated, by a legal rule that places determinative weight on which complaint was filed first.
>
> ... The mere fact that a lawyer filed first for a representative client is scant evidence of his adequacy and may, in fact, support the contrary inference.

820 A.2d at 1159 (footnote omitted). In lieu of first-to-file, this Court balances the factors pertinent to a *forum non conveniens* analysis to determine where it makes sense for the representative action to proceed. *See, e.g., Rosen v. Wind River Sys., Inc.,* 2009 WL 1856460, at *6 (Del.Ch. June 26, 2009); *In re Topps Co. S'holders Litig.,* 924 A.2d 951, 956–64 (Del.Ch.2007); *Ryan v. Gifford,* 918 A.2d 341, 350–51 (Del.Ch.2007).

This Court also adopted Rule 15(aaa), quoted above, to limit a plaintiff's ability to re-plead. Ct. Ch. R. 15(aaa). Under this rule, a plaintiff who files a derivative action cannot freely amend after engaging in briefing on the motion to dismiss. *See Braddock,* 906 A.2d at 783 (explaining purpose and operation of Rule 15(aaa)). By imposing consequences for litigating to a pleadings-stage decision, Rule 15(aaa) encourages plaintiffs to do their homework and prepare a well-crafted complaint.

The Delaware Supreme Court has rejected two other attempts by this Court to address the first-to-file problem, but in each case expressed support for the effort. In *King I,* Chancellor Strine held that by filing a derivative action, a stockholder plaintiff represented consistent with Rule 11 that the plaintiff and his counsel had sufficient information to plead demand futility and did not require additional information. *See* 994 A.2d at 356; *see also* Ct. Ch. R. 11. The Chancellor ruled that the stockholder plaintiff therefore could not plead a proper purpose in a later-filed Section 220 action to obtain books and records relating to the issue of demand futility. *Id.* at 361. In reaching this holding, the Chancellor discussed the incentives created by the first-to-file rule and sought to thwart efforts by fast-filing plaintiffs' lawyers to eat their cake (by filing quickly) while still having it (by obtaining books and records through Section 220). *Id.* at 357–59. The Delaware Supreme Court rejected this interpretation of the proper purpose requirement in cases where the derivative action had been dismissed without prejudice.[32] At the same ***349** time, the Delaware Supreme Court acknowledged the policy concerns that animated Chancellor Strine's decision. *King II,* 12 A.3d at 1150–51. Rather than addressing the first-to-file problem through the proper purpose requirement of Section 220, however, the Supreme Court suggested that "appropriate remedies are available in the plenary court" and that "[o]ne possible remedy for a prematurely-filed derivative action might be for the plenary court to deny the plaintiff 'lead plaintiff' status in such circumstances." *Id.* at 1151.

Similarly in *White I,* Vice Chancellor Lamb suggested that a plaintiff's failure to obtain books and records could be taken into account when evaluating whether a complaint's allegations were sufficiently particularized to satisfy Rule 23.1. *See* 793 A.2d at 364 (stating that because the plaintiff failed to use Section 220, "I will not give a broad reading to the facts alleged in the complaint, nor will I infer from them the existence of other facts that would have been proved or disproved by a further presuit investigation"). On appeal, the Delaware Supreme Court rejected this approach as inconsistent with Rule 23.1, but observed that "[t]he Court of Chancery was certainly justified in chastising the plaintiff for his lackluster pre-suit efforts." *White II,* 783 A.2d at 549. Chancellor Chandler tried again in *Beam v. Stewart,* where he suggested that Delaware Supreme Court decisions interpreting Rule 23.1 were "wholly consistent with [*White I*'s approach of] not giving 'a broad reading to the facts alleged in the complaint.' " *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart,* 833 A.2d 961, 982 n. 66 (Del.Ch.2003) ("*Beam I* "), *aff'd on other grounds,* 845

A.2d 1040 (Del.2004) ("*Beam II*"). He further suggested that "one might argue that following [*White I*'s] interpretive suggestion would be a reasonable method to further the Supreme Court's desire to encourage the use of § 220." *Id.* On appeal, the Delaware Supreme Court affirmed the dismissal of the complaint but reiterated that "[a] plaintiff's use of, or failure to use, a books and records inspection does not change the standard to be applied to review of the complaint." *Beam II,* 845 A.2d at 1057 n. 52. The Supreme Court nevertheless "agree[d] with the Chancellor's point about cost and drain on resources in weak cases where the plaintiff does not seek books and records." *Id.*

d. Applying The Fast–Filer Presumption

In *Rales,* the Delaware Supreme Court made clear that "[n]othing requires the Court of Chancery, or any other court having appropriate jurisdiction, to countenance [fast-filing] by penalizing diligent counsel who has employed [investigative] methods, including section 220, in a deliberate and thorough manner in preparing a complaint that meets the demand excused test of *Aronson.*" 634 A.2d at 934 n. 10; *see also King II,* 12 A.3d at 1151 (suggesting denial of lead plaintiff status as remedy for fast-filed derivative action). In my view, a court in a plenary derivative action such as this one has discretion to address a rush to the courthouse by determining that the plaintiff in the original derivative action did not provide adequate representation for the corporation and declining on that basis to give preclusive effect to a Rule 23.1 dismissal of the fast-filer's complaint. In this case, to give preclusive effect to the California Judgment would favor the lawyers who filed hastily, penalize ***350** the diligent counsel who used Section 220, and confer a case-dispositive advantage on the defendants at the potential expense of the corporation.

The origins of this case exemplify the race-to-the-courthouse problem. Less than 48 hours after Allergan announced its settlement, LAMPERS filed the first derivative complaint, without using Section 220, without conducting any serious investigation, and without any meaningful allegations that could defeat a demand-futility motion. Within weeks, three comparably scant complaints had been filed in the California Federal Court. These prematurely filed complaints were filed hastily for one reason only: to enable the specialized law firms to gain control of a case that could generate legal fees.

Fast-filing might have benefited the specialized law firms, but it did not benefit Allergan. The complaints forced Allergan to fund the teams of the lawyers hired by the individual defendants to respond in each jurisdiction, address coordination issues, and brief parallel motions to dismiss. The fast-filed complaints also forced two separate court systems to expend judicial resources on the litigation. Ironically, when one stockholder—UFCW—attempted to proceed properly by using Section 220, the defendants *and the fast-filing Delaware plaintiff* joined forces to oppose its effort to develop the facts needed to plead a complaint with a meaningful chance of success.

By leaping to litigate without first conducting a meaningful investigation, the California plaintiffs' firms failed to fulfill the fiduciary duties they voluntarily assumed as derivative action plaintiffs. Rather than seeking to benefit Allergan, they sought to benefit themselves by rushing to gain control of a case that could be harvested for legal fees. In doing so, the fast-filing plaintiffs failed to provide adequate representation.

Subsequent events did not transform the fast-filing plaintiffs into adequate representatives. True, the defendants voluntarily provided the California plaintiffs with the Section 220 materials, after UFCW invested the time and resources to obtain them, and the California plaintiffs used the materials to file an amended complaint. But in my view, the fast-filing plaintiffs already had shown where their true loyalties lay. Asking for and receiving the benefit of another lawyer's work did not rehabilitate them. It rather evidenced their continuing desire to control the case. In this regard, I disagree that the policy goal of encouraging

plaintiffs to use Section 220 will not be undercut by a rule that affords priority to fast filers if the corporation gives them the same books and records that a diligent stockholder fought to obtain. *But see Career Educ.,* 2007 WL 2875203, *10 n. 58 (asserting that policy of encouraging stockholders to use of Section 220 would not be undercut by allowing fast-filing plaintiffs to copy complaint prepared by stockholder who used Section 220 and then giving preclusive effect to dismissal in fast-filed action). Under the rule enunciated in *King I,* the issue would not arise because stockholders like the California plaintiffs would not be able to file fast, suffer dismissal, and then ask for books and records to try again.

Assuming *LeBoyer* accurately states the law of collateral estoppel as I am bound to apply it (a point with which I disagree), the doctrine does not require dismissal in the current case because the plaintiffs in the California Action provided inadequate representation for Allergan. Rather than representing the best interests of the corporation, the California plaintiffs sought to maximize the potential returns of the specialized ***351** law firms who filed suit on their behalf.

B. Rule 23.1

Having determined that collateral estoppel does not require judgment for the defendants, I must consider independently whether Rule 23.1 requires dismissal. Although not binding, the California Judgment is potentially persuasive.

Rule 23.1 requires that a derivative plaintiff "allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort." Ct. Ch. R. 23.1. For a board to consider a demand properly, a majority of the directors must be able to exercise their independent and disinterested business judgment about whether to pursue litigation. *Aronson,* 473 A.2d at 815. The Delaware plaintiffs contend that demand should be excused as futile because each of the directors would face a substantial risk of liability if the litigation were pursued.

[16] **[17]** The requirement of factual particularity does not entitle a court to discredit or weigh the persuasiveness of well-pled allegations. "The well-pleaded factual allegations of the derivative complaint are accepted as true on such a motion." *Rales,* 634 A.2d at 931. "Plaintiffs are entitled to all reasonable factual inferences that logically flow from the particularized facts alleged...." *Brehm,* 746 A.2d at 255. Put differently, once a plaintiff pleads particularized allegations, then the plaintiff is entitled to all "reasonable inferences [that] logically flow from particularized facts alleged by the plaintiff." *Beam II,* 845 A.2d at 1048. Rule 23.1 requires that a plaintiff allege specific facts, but "he need not plead evidence." *Id.* at 816; *accord Brehm,* 746 A.2d at 254 ("[T]he pleader is not required to plead evidence...."). A plaintiff also need not "plead particularized facts sufficient to sustain a 'judicial finding' either of director interest or lack of director independence" or other disabling factor. *Grobow,* 539 A.2d at 183. The Delaware Supreme Court in *Grobow* interpreted the Court of Chancery as having adopted a "judicial finding" standard and explicitly rejected it as "an excessive criterion" for pleading under the "reasonable doubt test." *Id.*

[18] Similarly, to show that a director faces a "substantial risk of liability," the plaintiff does not have to demonstrate a reasonable probability of success on the claim. In *Rales,* the Delaware Supreme Court rejected such a requirement as "unduly onerous." 634 A.2d at 935. "The purpose of [Rule 23.1's] heightened standard is to ensure only derivative actions supported by a reasonable factual basis proceed." *Dow Chem.,* 2010 WL 66769, at *6. Plaintiffs need only "make a threshold showing, through the allegation of particularized facts, that their claims have some merit." *Rales,* 634 A.2d at 934.

[19] In this case, the plaintiffs do not seek to impose liability on the Allergan directors for making a "wrong" business decision or taking imprudent business risks. *Cf. Citigroup,* 964 A.2d at 126 (dismissing *Caremark*

claim premised on taking excessive risk); *In re Goldman Sachs Gp., Inc. S'holder Litig.,* 2011 WL 4826104, *13–16 (Del.Ch. Oct. 12, 2011) (rejecting fiduciary duty claims based on alleged misalignment of interests created by compensation scheme). That type of "judicial second guessing is what the business judgment rule was designed to prevent." *Citigroup,* 964 A.2d at 126. "The business outcome of an investment project that is unaffected by director self-interest or bad faith, cannot itself be an occasion for director ***352** liability." *Gagliardi v. TriFoods Int'l Inc.,* 683 A.2d 1049, 1051 (Del.Ch.1996) (Allen, C.) (footnote omitted).

Corporate misconduct involving fraud or illegality presents a different situation. Even under a pure *Caremark* monitoring theory,

> [t]here are significant differences between failing to oversee employee fraudulent or criminal conduct and failing to recognize the extent of a Company's business risk. Directors should, indeed must under Delaware law, ensure that reasonable information and reporting systems exist that would put them on notice of fraudulent or criminal conduct within the company. Such oversight programs allow directors to intervene and prevent frauds or other wrongdoing that could expose the company to risk of loss as a result of such conduct.

Citigroup, 964 A.2d at 131. "[I]mposing *Caremark*-type duties on directors to monitor business risk is fundamentally different from imposing on directors a duty to monitor fraud and illegal activity." *Goldman Sachs,* 2011 WL 4826104, at *22 (internal quotation omitted).

[20] "Delaware law does not charter law breakers." *Massey Energy,* 2011 WL 2176479, at *20. "Delaware law allows corporations to pursue diverse means to make a profit, subject to a critical statutory floor, which is the requirement that Delaware corporations only pursue 'lawful business' by 'lawful acts.' " *Id.* (citing 8 *Del. C.* §§ 101 & 102). "Under Delaware law, a fiduciary may not choose to manage an entity in an illegal fashion, even if the fiduciary believes that the illegal activity will result in profits for the entity." *Metro Commc'n Corp. BVI v. Advanced Mobilecomm Techs. Inc.,* 854 A.2d 121, 163–64 (Del.Ch.2004).

> In short, by consciously causing the corporation to violate the law, a director would be disloyal to the corporation and could be forced to answer for the harm he has caused. Although directors have wide authority to take lawful action on behalf of the corporation, they have no authority knowingly to cause the corporation to become a rogue, exposing the corporation to penalties from criminal and civil regulators. Delaware corporate law has long been clear on this rather obvious notion; namely, that it is utterly inconsistent with one's duty of fidelity to the corporation to consciously cause the corporation to act unlawfully. The knowing use of illegal means to pursue profit for the corporation is director misconduct.

Desimone, 924 A.2d at 934–35 (footnote omitted). "As a result, a fiduciary of a Delaware corporation cannot be loyal to a Delaware corporation by knowingly causing it to seek profits by violating the law." *Massey Energy,* 2011 WL 2176479, at *20.

[21] The plaintiffs in this case have alleged a direct connection between the Board and a business plan premised on illegal activity. The Complaint pleads that from 1997 onward, the Board discussed and

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approved a series of annual strategic plans that contemplated expanding Botox sales dramatically within geographic areas that encompassed the United States. The plans contemplated new markets for Botox that involved applications that were off-label uses in the United States. So significant was the scope of the expansion that it necessarily contemplated marketing and promoting off-label uses within the United States. The Board then closely monitored Allergan's dramatic success in increasing its sales of Botox at rates far exceeding what the market for existing on-label uses could support or that could be generated by physicians serendipitously learning about and trying new off-label applications. The Board kept Allergan's business plan in ***353** place even after the Schim incident and FDA inquiries illustrated the extent of Allergan's regulatory exposure. From these allegations, one can reasonably infer that the Board knowingly approved and monitored a business plan that contemplated illegality.

Critically, the Complaint does not merely allege that this misconduct took place. Unlike the parade of hastily filed *Caremark* complaints that Delaware courts have dismissed, and like those rare *Caremark* complaints that prior decisions have found adequate, the Complaint supports these allegations with references to internal Allergan books and records that UFCW obtained using Section 220. For example, the Complaint references a slide presentation to the Board that summarized the Strategic Plan for 1997–2001. The presentation projected ramping up Botox sales *in North America* from $86.1 million to $141.1 million. Plan Slides at 5. A slide entitled “Top Corporate Priorities” identified “Maximize New Products” as the second of three bullet points. *Id.* at 10. The fourth bullet point under the “Maximize New Products” heading read “BOTOX—Spasticity, migraine, and pain.” *Id.* At the time, none were approved uses in the United States, which one can readily infer at the pleadings stage constituted a non-trivial part of the North American Botox-purchasing market.

Other slides in the deck provide further support for the inference that the Board-approved plan contemplated affirmative marketing and support for off-label uses. A slide described the “Charter” for the Botox “Business Portfolio Strateg[y]” *in North America* as “[i]nvest to grow new indications & develop follow-on toxins.” *Id.* at 5. It listed “[s]pasticity,” “[b]ack pain,” and “[h]ead ache.” *Id.* None were FDA-approved uses in the United States. Another slide entitled “Transitioning to a Future with Sustainable Growth” stated:

• BOTOX®, Tazorac®, Alphagan®, and Array® represent immediate growth

• Major opportunities exist to expand into other specialty therapeutic areas with tremendous growth

—*Back pain & head ache*

—*Oncology*

—*Diabetes*

• Expansion strategy enables Allergan to maximize Eye, Skin, & BOTOX® ***now,*** while establishing technology platforms to build our businesses in new areas.

Id. at 11. One can reasonably infer from these slides that the plan contemplated pursuing as “Top Corporate Priorities” new Botox uses not yet approved by the FDA as a source of “immediate growth” for Allergan and a means for “Allergan to maximize ... BOTOX® ***now.***”

The text of Allergan's actual, written strategic plan expanded on the points identified in the slides. It identified “Maximize New Products” as the number 1 item on Allergan's list of six “Top Corporate Priorities.” Written Plan at 14. The fourth bullet point under this number 1 item read: “*Botox*—Maximize sales for spasticity and new indications such as migraine.” *Id.* Neither was an FDA-approved use. The

section of the plan entitled “Corporate Portfolio Strategy” identified the “Role/Charter” for “*Botox*/ Neuromuscular” as follows: “Invest to develop follow-on toxins with improved performance characteristics that protect and expand our toxin franchise. Sales expected to grow from $94 million in 1997 to $215 million in 2001.” *Id.* at 22. The “Strategic Rationale” for this step was that

> *Botox* will continue to be one of Allergan's fastest growing business areas as ***354** usage expands to new indications and penetration expands in all regions. Investments in new indications of pain and migraine headache represent two of the top three future growth opportunities in our portfolio with combined peak year sales of $1.26 billion!

Id. One can reasonably infer that “all regions” included the United States, where “pain” and “migraine headaches” were off-label applications. *See also id.* at 3 (identifying Botox as one of “five core Allergan businesses” and describing the treatment as having “tremendous growth potential as we fund opportunities with new indications and uses such as spasticity, pain, migraine and tension headache”).

Allergan's plan projected that the company would enter the “Migraine Headache” market in 2001 and achieve estimated peak-year, risk-adjusted sales of $596 million. *Id.* at 5. “Migraine headache” was an off-label use. The plan also projected that Allergan would enter the back pain market in 2002 and achieve estimated peak-year, risk-adjusted sales of $666 million. *Id.* “Back pain” was an off-label use.

The plan further anticipated that Allergan's sales growth would be driven in part by “continued growth from *Botox* ” and that Allergan's improvement in gross profit margin would be “driven by changes in the sales mix as sales growth comes from higher priced and higher margin products such as *Alphagan, Botox,* and *Zorac.*” *Id.* at 8. The plan further noted that

> Allergan is at the beginning of major new product launches with *Alphagan, Zorac,* the *Array* IOL and new indications for *Botox.* Each of these new product opportunities represents significant advances in technology which have the potential to change the way physicians approach the management of their patients' conditions. Also they all participate in relatively large markets. As a result, there are best case scenarios for these products which are not prudent to include in our projections, but which do represent potential upside opportunities.

Id. at 9. The plan warned that Allergan was largely dependent on these products, and that “[t]he majority of Allergan's growth over the next five years is expected to come from *Alphagan, Array* IOL, *Zorac* and *Botox.*” *Id.* at 10.

As the Complaint alleges, Allergan pursued the Board's strategic plan by deploying an array of programs to support off-label Botox use. These efforts included sponsoring physicians to speak about and promote off-label use, assisting physicians in seeking reimbursement for off-label use, and providing pricing support to promote off-label use. The strategic plan specifically cited “U.S.-Reimbursement assistance” as one of the reasons “*Why Customers Buy From Us Now.*” *Id.* at 59.

The Complaint pleads that the Board regularly monitored Botox sales and cites specific occasions where the Board was made aware of growth in average daily sales and the revenue mix across different usage

categories. The Complaint specifically pleads that between 2000 and 2004, Botox achieved annual sales growth of 25% to 42%, despite being approved by the FDA for only four uses where demand was limited. Off-label sales skyrocketed with spasticity sales growing by 332%, headache sales by 1,407%, and pain sales by 504%. Although it is not the only possible inference, one can reasonably infer at the pleadings stage that the Board knew physicians were not harmonically converging on off-label uses in the same areas that Allergan happened to be targeting aggressively for sales growth.

The Complaint specifically pleads that in October 2006, the Board learned that the FDA was inquiring about off-label marketing ***355** by Dr. Schim, an Allergan-sponsored speaker. The Board was advised that the dinner programs at which Dr. Schim spoke were "directly funded, hosted, and controlled by Allergan," and that "the presentations are considered commercial promotion and Allergan is responsible for their content." German Aff. Ex. E. The Board was further advised that Allergan business and marketing personnel knew about Dr. Schim's non-compliant materials and failed to take responsibility for addressing his promotion of off-label uses. The directors were told by in-house counsel that "[t]his is a potentially serious matter and in the current environment, the chance of receiving Agency action, including but not limited to a Warning Letter, on this matter is ... very high." *Id.*

The Complaint pleads that after the Schim incident, the Board approved the 2007–2011 Strategic Plan which explicitly linked the number of sales representatives to increased off-label sales. During the same period, the Board continued to receive detailed reports on Botox sales and the revenue mix, including reports showing that 70% to 80% of Botox sales were generated from off-label use. These particularized allegations support a reasonable inference that the Board knew Allergan personnel were engaging in or turning a blind-eye towards illegal off-label marketing and promotion and that the Board nevertheless decided to continue Allergan's existing business practices in pursuit of greater sales.

Ten of the twelve defendant directors have served on the Board since 2005 and earlier. One can reasonably infer that these directors approved multiple iterations of Allergan's strategic plan, monitored Botox's explosive sales growth, learned of the Schim incident in October 2006, then approved the 2007 Strategic Plan, fully conscious of the role of off-label marketing in Allergan's success. The inference is more tenuous for Dunsire and Hudson, who joined the Board in 2006 and 2008, respectively. Because the Complaint implicates more than half of the Board, I need not make any determination one way or the other as to those two directors.

It is not unreasonable to infer that the Allergan Board, led by a hard-charging CEO who earned the nickname "Mr. Botox," could have believed that Allergan knew better than the FDA which Botox applications were safe, particularly off-label uses already approved (or at least permitted) in other countries. It is not unreasonable to infer that the Board and CEO saw the distinction between off-label selling and off-label marketing as a source of legal risk to be managed, rather than a boundary to be avoided. [33] Based on this ***356** premise, the CEO and his management team devised, and the Board approved, a business plan that relied on off-label-use-promoting activities, confident that the risk of regulatory detection was low, that most regulatory problems could be solved, and that dealing with regulatory risk was a cost of doing business. [34] As profits increased and the regulatory risk seemed well managed, the extent of off-label use-promoting activities grew. The appearance of formal compliance cloaked the reality of non-compliance, and directors who understood the difference between legal off-label sales and illegal off-label marketing continued to approve and oversee business plans that depended on illegal activity. *See Massey Energy,* 2011 WL 2176479, at *19 (crediting inference that outside directors went "through the motions" rather than making "good faith efforts to ensure that [the company] cleaned up its act").

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Obviously this is not the only inference that can be drawn. Alternatively, one could infer that the directors received advice from sophisticated counsel about the difference between legal off-label sales and illegal off-label marketing, understood where the boundary lay, and approved a business plan and management initiatives in the good faith belief that Allergan was remaining within the bounds of the law, although perhaps close to the edge. The directors then closely monitored Allergan's performance with this understanding. Unfortunately for everyone, the directors' good faith belief proved incorrect, and Allergan pled guilty to criminal misdemeanor misbranding for the period from 2000 through 2005, paid criminal fines of $375 million, and paid another $225 million in civil fines. If this scenario proves true, then the directors will not have acted in bad faith and will not be liable to Allergan for any of the harm it suffered. *See id.* at *22.

I cannot presently determine what actually happened at Allergan. I hold only that a reasonable inference can be drawn from the particularized allegations of the Complaint and the documents it incorporates by reference that the Board knowingly approved and subsequently oversaw a business plan that required illegal off-label marketing and support initiatives for Botox. At this stage of the case, I must credit this inference, even if I believe it more likely that the directors acted in good faith. The complaint need not "plead particularized facts sufficient to sustain 'a judicial finding' either of director interest or lack of director independence" or other disabling factor. *Grobow,* 539 A.2d at 183. Nor must it demonstrate a reasonable probability of success. *Rales,* 634 A.2d at 934–35. The complaint needs only to make a "threshold showing, through the allegation of particularized facts, that their ***357** claims have some merit." *Id.* at 934. I believe the Complaint meets this standard.

In reaching this conclusion, I part company with the California Federal Court and find unpersuasive the analysis in the California Judgment. The California Federal Court correctly described Delaware law in stating that that the California complaint only could survive a Rule 23.1 motion to dismiss if the particularized allegations presented the directors with a substantial threat of liability. The California Federal Court nevertheless determined that the California complaint failed to meet this test.

The California Federal Court held that the California complaint fell short because "[t]here is still no evidence of a *decision* by board members to promote the use of off-label marketing, nor are there any facts suggesting that the Directors would be incapable of making an impartial decision concerning litigation. The 1997–2001 Strategic Plan makes no mention of off-label marketing." California Judgment at 4. The California Federal Court stated that the "Top Corporate Priorities" slide listed bullet points, "the first of which does not even mention Botox." *Id.* As the California Federal Court recognized in denying the plaintiffs' motion for reargument, the fourth bullet point identified Botox as one of four products the sales of which Allergan sought to maximize. *In re Allergan Inc. S'holder Deriv. Action,* Case No. SACV 10–1352, at 3 (C.D.Cal. Feb. 22, 2012). As discussed above, the underlying written plan identified "Maximize New Products" as the number 1 item on Allergan's list of six "Top Corporate Priorities." German Aff. Ex. D at 14. The fourth bullet point under this number 1 item reads: "*Botox*—Maximize sales for spasticity and new indications such as migraine." *Id.* Neither was an FDA-approved use.

In my view, a plaintiff does not have to point to actual confessions of illegality by defendant directors to survive a Rule 23.1 motion in a *Caremark* case. Particularly at the pleadings stage, a court can draw the inference of wrongful conduct when supported by particularized allegations of fact. [35] Given that off-label marketing is illegal, it would be astounding if the 1997–2001 Strategic Plan or any other board presentation actually used that term. If in-house counsel hoped to keep their jobs, those words only could make it into a board presentation in the context of a statement against the practice. But sadly, sophisticated corporate actors at times engage in illegal behavior and attempt to hide their misconduct with the appearance of legal compliance. Having reviewed the summary slides and the underlying strategic plans, I believe there are sufficient references in the documents to support a reasonable inference that Allergan expected to drive

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increased sales by promoting off-label use. When, as here, the pled ***358** facts can support a reasonable inference that directors *in fact* approved a business plan that contemplated off-label marketing, the plaintiffs receive the benefit of the inference at the pleadings stage.

The California Federal Court similarly concluded that a Board-sanctioned “Headache Development” program for Botox “had absolutely nothing to do with marketing; rather, it was a clinical presentation regarding Botox's potential efficacy in treating migraines.” California Judgment at 4. The California Federal Court likewise dismissed the sufficiency of the allegation that the Board oversaw a “Cervical Dystonia/ Headache Expansion Initiative” by noting that cervical dystonia was an approved FDA use at the time. *Id.*

In my view, both descriptions adopt one possible and defendant-friendly interpretation of the underlying documents and related allegations. At the pleadings stage, I believe the plaintiffs are entitled to the reasonable inference that the Board oversaw company-wide efforts to promote off-label use of Botox for treating migraine headaches, which was not an FDA-approved use at the time.

The California Federal Court also held that the Board's knowledge of the Schim incident did not demonstrate wrongdoing by the Board. According to the California Judgment, “[n]ot only was the presentation approved prior to the presentation without the offending slides, but the Directors took appropriate remedial action after learning of the presentation.” *Id.* (citing defendants' motion). Whether the directors took “appropriate remedial action” is unclear and strikes me as a factual issue that reasonably could be disputed at this stage of the case. Regardless, as I understand the plaintiffs' theory, the argument is not that the Schim incident itself established wrongdoing. The point rather is that the Schim incident should have further illuminated the serious legal risks posed by Allergan's various programs for supporting off-label use, including its sponsored-speaker program, and the existence of a culture of non-compliance at the company. Despite being confronted with this red-flag, the directors subsequently approved iterations of the business plan that further ramped up Allergan's support for off-label use. It may be that the directors in fact acted in good faith after the Schim incident and when taking these steps, but at the pleadings stage I do not believe that I can adopt a defendant-friendly interpretation of the plaintiffs' allegations.

As should be abundantly clear, this is a pleadings-stage decision. To prevail ultimately, the plaintiffs actually will have to prove their claims. At later stages of the case, the plaintiffs will not be entitled to pleadings-stage presumptions, and the defendants will have strong arguments against liability. *See Massey Energy,* 2011 WL 2176479, at *20–21. For present purposes, however, the plaintiffs need only plead particularized allegations that support a reasonable inference that their claims have “some merit.” *Rales,* 634 A.2d at 934. Because the plaintiffs have met this standard, the Rule 23.1 motion is denied.

C. Rule 12(b)(6)

“The standard for pleading demand futility under Rule 23.1 is more stringent than the standard under Rule 12(b)(6)....” *Citigroup,* 964 A.2d at 139. A complaint that pleads a substantial threat of liability for purposes of Rule 23.1 “will also survive a 12(b)(6) motion to dismiss.” *McPadden v. Sidhu,* 964 A.2d 1262, 1270 (Del.Ch.2008). Accordingly, the Rule 12(b)(6) motion is denied.

III. CONCLUSION

As Chancellor Allen famously observed, a *Caremark* theory “is possibly the most ***359** difficult theory in corporation law upon which a plaintiff might hope to win a judgment.” 698 A.2d at 967. But “difficult” does not mean “impossible,” and “win a judgment” does not mean “survive a motion to dismiss.”

Under my understanding of controlling Delaware Supreme Court precedent, collateral estoppel does not mandate dismissal. Separately and independently, by filing hastily and failing to conduct a meaningful investigation, the California plaintiffs acted self-interestedly and contrary to Allergan's best interests. They did not provide adequate representation, rendering collateral estoppel inapplicable.

On the merits of the Rule 23.1 motion, the California Judgment is not persuasive because it adopts one possible defendant-friendly inference from the pled facts. Even under Rule 23.1, the plaintiffs receive the benefit of reasonable inferences that can be drawn from adequately pled facts. Here, the particularized allegations support a reasonable inference that the Board knowingly approved a business plan that contemplated illegal off-label marketing in the United States. The particularized allegations of the Complaint, which are supported by internal documents obtained through Section 220, present a substantial threat of liability for all but two members of the Board.

Demand is therefore excused as futile. For the same reasons, the Complaint states a claim under Rule 12(b)(6). The motions to dismiss are denied. IT IS SO ORDERED.

All Citations

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Footnotes

1 *See, e.g., In re Sonus Networks, Inc., S'holder Deriv. Litig.,* 499 F.3d 47 (1st Cir.2007); *Arduini ex rel. Int'l Game Tech. v. Hart,* 2012 WL 893874 (D.Nev. Mar. 14, 2012); *In re Bed Bath & Beyond Inc. Deriv. Litig.,* 2007 WL 4165389 (D.N.J. Nov. 19, 2007); *Hanson v. Odyssey Healthcare, Inc.,* 2007 WL 5186795 (N.D.Tex. Sept. 21, 2007); *LeBoyer v. Greenspan,* 2007 WL 4287646 (C.D.Cal. June 13, 2007); *Henik ex rel. LaBranche Co. v. LaBranche,* 433 F.Supp.2d. 372 (S.D.N.Y.2006); *In re Career Educ. Corp. Deriv. Litig.,* 2007 WL 2875203 (Del.Ch. Sept. 28, 2007); *Carroll ex rel. Pfizer, Inc. v. McKinnell,* 19 Misc.3d 1106(A), 2008 WL 731834 (N.Y.Sup.Ct.2008).

2 *See* U.S. Const. art. IV, § 1 ("Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State. And the Congress may by general Laws prescribe the Manner in which such Acts, Records and Proceedings shall be proved, and the Effect thereof."); 28 U.S.C. § 1738 ("Acts [of the legislature of any State, Territory, or Possession of the United States and] records and judicial proceedings [of any such State, Territory or Possession] ... shall have the same full faith and credit in every court within the United States and its Territories and Possessions as they have by law or usage in the courts of such State, Territory or Possession from which they are taken."); *Thompson v. D'Angelo,* 320 A.2d 729, 734 (Del.1974) ("We ... note that as long as the order of the [United States] District Court [for the Eastern District of Pennsylvania] stands it is the duty of the Courts of this State to accord it the same force and effect as would be given to it by a Pennsylvania Court."); *W. Coast Mgmt. & Capital, LLC v. Carrier Access Corp.,* 914 A.2d 636, 642 (Del.Ch.2006) ("This court gives the same preclusive effect to the judgment of another state or federal court as the original court would give.").

3 *Compare, e.g., Ex parte Capstone Dev. Corp.,* 779 So.2d 1216, 1218–19 (Ala.2000) (deeming a Rule 23.1 dismissal to be a decision based on a precondition and therefore not "upon the merits" for purposes of preclusive effect) *and Kaplan v. Bennett,* 465 F.Supp. 555, 561–62 (S.D.N.Y.1979) (same) *with Bed Bath & Beyond,* 2007 WL 4165389, at *6 ("A dismissal for failure to make demand on a board is considered substantive and, therefore, on the merits.") *and LeBoyer,* 2007 WL 4287646, at *2 (holding that under the internal affairs doctrine, Delaware law determines whether a Rule 23.1 dismissal is "on the merits") *and Henik,* 433 F.Supp.2d. at 379 (citing federal authorities to hold that a Rule 23.1 dismissal with prejudice is a "final adjudication" and "on the merits"). *See also Sonus Networks,* 499 F.3d at 59–62 (holding that a Rule 23.1 dismissal is binding as to demand futility regardless of the meaning of "on the merits").

4 *Compare, e.g., W. Coast Mgmt.,* 914 A.2d at 643 n. 22 (suggesting that the issue decided in the original case should be limited to the allegations supporting demand futility that were made by that derivative plaintiff) *with Bed Bath & Beyond,* 2007 WL 4165389, at *6 ("[B]ecause the prior plaintiff did not plead every possible cause of action or include every possible time period or defendant does not alter the central issue—whether demand on the BBB board would have been futile—which has already been determined by the New York court.") *and LeBoyer,* 2007 WL 4287646, at *2 ("[T]he issue here—whether a demand on the board to sue the directors over the 2003 restatement would have been futile—is the same.").

5 *Compare, e.g., W. Coast Mgmt.,* 914 A.2d at 643 n. 22 (suggesting not giving issue preclusive effect to original complaint if subsequent complaint contains substantial additional facts developed using Section 220) *with Sonus Networks,* 499 F.3d at 62–63 (giving issue preclusive effect where facts were not alleged in original complaint but original plaintiff could have obtained the information) *and Arduini,* 2012 WL 893874, at *3 (noting that "Plaintiff's arguments that he has allegations specific to the demand futility issue that are different from the allegations brought up in [the underlying proceeding do not] preclude our use of issue preclusion").

6 *Compare Henik,* 433 F.Supp.2d. at 381 (applying both *res judicata* and collateral estoppel to Rule 23.1 determination) *and Bed Bath & Beyond,* 2007 WL 4165389, at *8 (holding that relitigation of demand futility is precluded under the doctrine of claim preclusion) *with Sonus Networks,* 499 F.3d at 60–62 (holding that a Rule 23.1 determination only gives rise to issue preclusion and not claim preclusion).

7 *See, e.g., Arduini,* 2012 WL 893874, at *3 (holding that privity was satisfied in giving preclusive effect to Rule 23.1 dismissal because "plaintiffs in a shareholder derivative action represent the corporation"); *Bed Bath & Beyond,* 2007 WL 4165389, at *7 (finding privity met for preclusive application of Rule 23.1 dismissal because "[t]he claims alleged and any proceeds from a prior action do not belong to the shareholder plaintiffs; rather, they belong to the corporation itself"); *Hanson,* 2007 WL 5186795, at *5 (holding privity existed; "because shareholder derivative suits are brought on behalf of the corporation, it follows that the corporation is bound by the results of the suit in subsequent litigation, even if different shareholders prosecute the suits" (internal quotation omitted)); *Bennett,* 465 F.Supp. at 560 (holding that successive derivative actions involved the same party for purposes of preclusive effect of Rule 23.1 dismissal because the corporation "was the real party in interest in the other suits and is so here, regardless of the nominal plaintiffs"); *Carroll,* 2008 WL 731834, at *8 (finding privity met because "there is no difference between the plaintiffs in the Pfizer Derivative MDL and plaintiff here. Each plaintiff seeks to assert claims on behalf of Pfizer, not individual claims. Thus, plaintiff is bound by the determination in that case.").

8 In *Brehm v. Eisner,* 746 A.2d 244, 253–54 (Del.2000), the Delaware Supreme Court overruled seven precedents, including *Aronson,* to the extent those precedents reviewed a Rule 23.1 decision by the Court of Chancery under an abuse of discretion standard or otherwise suggested deferential appellate review. *See id.* at 253 n. 13 (overruling in part on this issue *Scattered Corp. v. Chicago Stock Exch.,* 701 A.2d 70, 72–73 (Del.1997); ***Grimes** v. **Donald**,* 673 A.2d 1207, 1217 n. 15 (Del.1996); *Heineman v. Datapoint Corp.,* 611 A.2d 950, 952 (Del.1992); *Levine v. Smith,* 591 A.2d 194, 207 (Del.1991); *Grobow v. Perot,* 539 A.2d 180, 186 (Del.1988); *Pogostin v. Rice,* 480 A.2d 619, 624–25 (Del.1984); and *Aronson,* 473 A.2d at 814). The *Brehm* Court held that going forward, appellate review of a Rule 23.1 determination would be *de novo* and plenary. *Brehm,* 746 A.2d at 254. The seven partially overruled precedents otherwise remain good law. In this decision, I do not rely on any of them for the standard of appellate review. Although the technical rules of legal citation would require noting that each was reversed on other grounds by *Brehm,* I have chosen to omit the cumbersome subsequent history, which creates the misimpression that *Brehm* rejected core elements of the Delaware derivative action canon.

9 *See Schoon v. Smith,* 953 A.2d 196, 201–02 (Del.2008) (tracing history of derivative action and explaining its dual nature); *Spiegel v. Buntrock,* 571 A.2d 767, 773 (Del.1990) (quoting *Aronson* for the "two-fold" nature of the derivative action); *Sternberg v. O'Neil,* 550 A.2d 1105, 1124 n. 41 (Del.1988) ("The normal derivative suit was 'two suits in one: (1) The plaintiff brought a suit in equity against the corporation seeking an order against it; (2) to bring a suit for damages or other legal injury for damages or other relief against some third person who had caused legal injury to the corporation.' " (quoting Robert C. Clark, *Corporate Law* 639–40 (1986))); *Peat, Marwick,* 540 A.2d at 730 (quoting *Aronson* in describing the "two-fold" nature of the derivative action); *Zapata,* 430 A.2d at 784 (citing "the 'two phases' of a derivative suit, the stockholder's suit to compel the corporation to sue and the corporation's suit").

10 *See, e.g., In re First Interstate Bancorp Consol. S'holder Litig.,* 729 A.2d 851, 859 n. 8 (Del.Ch.1998) ("The doctrine of judicial estoppel precludes a party 'from asserting in a legal proceeding, a position inconsistent with

a position previously taken by him in the same or in an earlier proceeding.' " (quoting *Coates Int'l, Ltd. v. DeMott,* 1994 WL 89018, at *5 (Del.Ch. Feb. 4, 1994))); *see also Rissetto v. Plumbers & Steamfitters Local 343,* 94 F.3d 597, 600 (9th Cir.1996) ("Judicial estoppel, sometimes also known as the doctrine of preclusion of inconsistent positions, precludes a party from gaining an advantage by taking one position, and then seeking a second advantage by taking an incompatible position."); *InterGen N.V. v. Grina,* 344 F.3d 134, 144 (1st Cir.2003) ("As a general matter, the doctrine of judicial estoppel prevents a litigant from pressing a claim that is inconsistent with a position taken by that litigant either in a prior legal proceeding or in an earlier phase of the same legal proceeding."); *cf. Transclean Corp. v. Jiffy Lube Int'l, Inc.,* 474 F.3d 1298 (Fed.Cir.2007) (holding that when plaintiff argued that privity existed for purposes of merits, judicial estoppel prevented plaintiff from reversing position to resist collateral estoppel).

11 For similar propositions, *see, e.g., Cramer v. Gen. Tel. & Elecs. Corp.,* 582 F.2d 259, 269 (3d Cir.1978) ("Nonparty shareholders are usually bound by a judgment in a derivative suit on the theory that the named plaintiff represented their interests in the case."); *Dana v. Morgan,* 232 F. 85, 89 (2d Cir.1916) (explaining that a stockholder derivative "action is really the action of all the stockholders, as it is necessarily commenced in their behalf and for their benefit. And as in such suits the wrong to be redressed is the wrong done to the corporation and as the corporation is a necessary part to the suit, it inevitably follows that there can be but one adjudication on the rights of the corporation. And it is undoubted law that the judgment in the state court is an estoppel and a finality not only as to all matters actually litigated in the suit but also as to all matters which were not but might have been presented to the court and passed upon therein."); *Parkoff v. Gen. Tel. & Elecs. Corp.,* 53 N.Y.2d 412, 442 N.Y.S.2d 432, 425 N.E.2d 820, 824 (1981) ("Because the claim asserted in a stockholder's derivative action is a claim belonging to and on behalf of the corporation, a judgment rendered in such an action brought on behalf of the corporation by one shareholder will generally be effective to preclude other actions predicated on the same wrong brought by other shareholders.").

12 The ***Grimes*** Court also made clear that the same stockholder plaintiff can subsequently make a litigation demand, use Section 220 to explore whether the demand was wrongfully refused, and (if appropriate) file a demand-refused case. *See* 673 A.2d at 1218–19; *see also Spiegel,* 571 A.2d at 776–77. By filing the original demand futility complaint, the stockholder does not does not concede the independence or disinterestedness of the board for purposes of alleging wrongful refusal (as opposed to demand futility). *Scattered Corp.,* 701 A.2d at 74–75; ***Grimes****,* 673 A.2d at 1219. A stockholder who makes demand concedes that the board is disinterested and independent with respect to the demand and therefore cannot argue that demand should have been excused as futile; he only can argue that the demand was wrongfully refused. *Spiegel,* 571 A.2d at 775. Contrary to ***Grimes****,* at least one court has applied preclusion principles broadly to bar subsequent efforts to plead wrongful refusal. *See Carroll,* 2008 WL 731834, at *10 (applying Delaware law and holding that "plaintiff may not relitigate the issue of the Board's independence and disinterest [in the demand refusal context] because the Federal Court already conclusively resolved this issue [in the demand futility context]"). Under ***Grimes****,* this holding appears incorrect.

13 *See Career Educ.,* 2007 WL 2875203, at *10 (citing *LeBoyer, Henik,* and *Sonus Networks*); *see also Norfolk Cty. Ret. Sys. v. Jos. A. Bank Clothiers, Inc.,* 2009 WL 353746, at *7–9 (Del.Ch. Feb. 12, 2009) (discussing the federal preclusion approach adopted in *Career Education* and denying Section 220 inspection after Rule 23.1 dismissal of earlier derivative action brought a by different stockholder).

14 *See, e.g., Henik,* 433 F.Supp.2d at 380 ("[I]f [preclusion] were not the rule, shareholder plaintiffs could indefinitely relitigate the demand futility question in an unlimited number of state and federal courts, a result the preclusion doctrine specifically is aimed at avoiding."); *see also Bed Bath & Beyond,* 2007 WL 4165389, at *7 (quoting *Henik*); *Hanson,* 2007 WL 5186795, at *7 (quoting *Henik*); *Levin ex rel. Tyco Int'l Ltd. v. Kozlowski,* 13 Misc.3d 1236(A), 2006 WL 3317048, at *14 (N.Y.Sup.Ct. Nov. 14, 2006) (quoting *Henik*), *aff'd,* 45 A.D.3d 387, 846 N.Y.S.2d 37 (2007).

15 *See, e.g., Sonus Networks,* 499 F.3d at 64 ("[T]o bind the corporation, the shareholder plaintiff must have adequately represented the interests of the corporation."); *Henik,* 433 F.Supp.2d at 381 ("It should be noted that there may be grounds warranting a different preclusion analysis and result where the plaintiff shareholder in the first action is alleged to have inadequately represented the interests of all of the shareholders."); *Hanson,* 2007 WL 5186795, at *6 ("[C]ollateral estoppel is improper where the interests of nonparty plaintiffs facing preclusion were not adequately represented in the prior litigation."); *Norfolk Cty.,* 2009 WL 353746, at *8 ("If a subsequent plaintiff makes credible allegations that the interests of the corporation were not suitably represented in the prior proceeding, collateral estoppel may not apply."); *Career Educ.,* 2007 WL 2875203, at *10 ("Where

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a plaintiff alleges that the interests of the corporation were not suitably represented in the prior proceeding collateral estoppel may not apply."). *See generally* Judgments § 42 ("A person is not bound by a judgment for or against a party who purports to represent him if ... [t]he representative failed to prosecute or defend the action with due diligence and reasonable prudence, and the opposing party was on notice of facts making that failure apparent.").

16 *See* Reinier Kraakman et al., *When Are Shareholder Suits in Shareholder Interests?,* 82 Geo. L.J. 1733, 1733 (1994) ("Shareholder suits are the primary mechanism for enforcing the fiduciary duties of corporate managers."); Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform,* 58 U. Chi. L.Rev. 1, 10 (1991) ("The shareholder's derivative suit is one of many devices in corporate law for controlling these conflicts between managers and shareholders."); **Donald** E. Schwartz, *In Praise of Derivative Suits: A Commentary on the Paper of Professors Fischel and Bradley,* 71 Cornell L.Rev. 322, 323 (1986) ("Liability rules, enforced by shareholder litigation, are theoretically sound and profoundly affect the conduct of corporate managers, at least some aspects of their duties.").

17 *See, e.g., In re Citigroup Inc. S'holder Deriv. Litig.,* 964 A.2d 106, 117 (Del.Ch.2009) ("A shareholder plaintiff in a derivative suit alleges claims in the right of the corporation rather than directly; thus, representative actions raise the concern that the best interest of the class might diverge from the best interest of the representative plaintiff's attorneys."); *Biondi v. Scrushy,* 820 A.2d 1148, 1159 (Del.Ch.2003) ("[R]epresentative actions pose certain dangers—in particular, the potential divergence in the best interests of the plaintiffs' attorneys and the plaintiffs they are purporting to represent ...."), *aff'd sub nom. In re HealthSouth Corp. S'holders Litig.,* 847 A.2d 1121 (Del.2004); Stephen A. Saltzburg et al., *Third Circuit Task Force Report on Selection of Class Counsel,* 74 Temp. L.Rev. 689, 706–07 (2001) (discussing divergent interests); Macey & Miller, *supra,* at 17–18 (same); John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions,* 86 Colum. L.Rev. 669, 684–91 (1986) (same).

18 *See, e.g.,* Elliot J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions,* 104 Yale L.J.2053, 2062 (1995) ("Courts most often appoint as lead counsel the lawyer who files the first complaint. Thus, plaintiffs' lawyers 'race to the courthouse.' " (footnote omitted)). In *King II,* the Delaware Supreme Court stated that "[b]eing the 'first to file' does not automatically confer lead-plaintiff status." 12 A.3d at 1151. Within Delaware, that statement is true, and the Court cited two Chancery decisions in support. *Id.* Outside of Delaware, the answer is far from clear. The *King II* decision cited a Ninth Circuit case and one decision from each of the Northern District of California, the Northern District of Georgia, and the Northern District of Illinois in which the courts considered more than filing speed. *See id.* at 1151 n. 66. I suspect that this sample is not representative, that many counsel selection decisions are not published, and that first-to-file still plays a significant role. *See* John Armour et al., *Is Delaware Losing Its Cases?* 37 (European Corporate Governance Inst., Law Working Paper No. 151/2010, 2012), *available at* http://ssrn.com/abstract=1578404 (reporting that "interviewees told us that the first-to-file 'custom' nevertheless remains important" outside of Delaware and that "[w]hen plaintiffs' lawyers cannot resolve for themselves who should be lead counsel, judges outside Delaware often appoint as lead or co-lead counsel the firm that filed first"); *see also Walker v. Discover Fin. Servs.,* 2011 WL 2160889, at *3 (N.D.Ill. May 26, 2011) (utilizing filing speed as proxy for amount of work by counsel in "identifying and investigating potential claims"); *Wright v. Krispy Kreme Doughnuts, Inc.,* 232 F.R.D. 528, 530–31 (M.D.N.C.2005) (appointing first-filer as lead plaintiff over plaintiff that opted to first pursue books and records action). Regardless, whether jurisdictions actually give significant weight to first-to-file has less significance for influencing filing behavior than lawyer perception.

19 *See* Edward P. Welch, et al., *Mergers & Acquisitions Deal Litigation Under Delaware Corporation Law* § 2.01[B][3][a], at 2–16 to –17 (noting that "either defendants or plaintiffs may cite to the 'first-to-file' rule" to support a motion to dismiss or stay later-filed actions in other jurisdictions (footnotes omitted)); Armour et al., *supra,* at 6 (noting that while defendants can seek a stay or dismissal by filing a *forum non conveniens* motion, "success ... is not assured, with the likelihood of success decreasing if the case was filed first in that state court"); Geoffrey P. Miller, *Overlapping Class Actions,* 71 N.Y.U. L.Rev. 514, 522 (1996) (reporting that "courts are more likely to defer to sister-state proceedings if the parallel case was filed first").

20 *Rales,* 634 A.2d at 934. In *Aronson,* the Delaware Supreme Court first crafted a specific two-part version of the subsequently articulated *Rales* test that applies when a derivative plaintiff challenges a board decision made by the same directors who remain in office at the time suit is filed. *Compare Aronson,* 473 A.2d at 814

(articulating two-part test where board composition did not change) *with Rales,* 634 A.2d at 933–34 (explaining that "[c]onsistent with the context and rationale of the *Aronson* decision, a court should not apply the *Aronson* test for demand futility where the board that would be considering the demand did not make a business decision which is being challenged in the derivative suit."). The *Rales* test addresses the same concerns that animate the *Aronson* test and frames the more comprehensive standard. *See David B. Shaev Profit Sharing Account v. Armstrong,* 2006 WL 391931, at *4 (Del.Ch. Feb. 13, 2006) ("the *Rales* test, in reality, folds the two-pronged *Aronson* test into one broader examination"); *Guttman,* 823 A.2d at 501 ("At first blush, the *Rales* test looks somewhat different from *Aronson,* in that [it] involves a singular inquiry.... Upon closer examination, however, that singular inquiry makes germane all of the concerns relevant to both the first and second prongs of *Aronson.*"); **Donald** J. Wolfe, Jr. & Michael A. Pittenger, *Corporate and Commercial Practice in the Delaware Court of Chancery* § 9.02[b][3] [iii], at 9–97 (2011) ("[I]t is arguable that the current state of the law is conceptually inverted and that it would be both simpler and more direct to regard the original *Aronson* analysis as a subpart of the more generally applicable and flexible principle set forth in *Rales*."). To recognize the tests as complementary versions rather than exclusive alternatives becomes particularly important for a mixed board where only a subset of the directors made the original decision. As to those directors, *Aronson* helpfully focuses the demand-futility analysis; as to the new directors, *Rales* frames the overarching test.

21 *Caremark,* 698 A.2d at 970; *see, e.g., Stone,* 911 A.2d at 364 (evaluating claim under failure-to-monitor branch of *Caremark* when "the plaintiffs acknowledge that the directors neither knew nor should have known that violations of law were occurring, *i.e.,* that there were no red flags before the directors" (alteration and internal quotation omitted)); *Shaev,* 2006 WL 391931, at *1 (evaluating claim under failure-to-monitor branch of *Caremark* after noting that the plaintiffs had no indications that the director defendants had any contemporaneous knowledge of the alleged misconduct by Citigroup employees).

22 *See, e.g., Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart,* 845 A.2d 1040, 1056–57 (Del.2004) ("Both this Court and the Court of Chancery have continually advised plaintiffs who seek to plead facts establishing demand futility that the plaintiffs might successfully have used a Section 220 books and records inspection to uncover such facts."); *White v. Panic,* 783 A.2d 543, 556–57 (Del.2001) ("[T]his case demonstrates the salutary effects of a rule encouraging plaintiffs to conduct a thorough investigation, using the 'tools at hand' including the use of actions under 8 *Del. C.* § 220 for books and records, before filing a complaint.... [F]urther pre-suit investigation in this case may have yielded the particularized facts required to show that demand is excused or it may have revealed that the board acted in the best interests of the corporation." (footnote omitted)); *Brehm,* 746 A.2d at 266–67 (disregarding plaintiffs' complaint "that the system of requiring a stockholder to plead particularized facts in a derivative suit is basically unfair because the Court will not permit discovery under Chancery Rules 26–37 to marshal the facts necessary to establish that pre-suit demand is excused," reasoning that "[p]laintiffs may well have the 'tools at hand' to develop the necessary facts for pleading purposes ... [by] seek[ing] relevant books and records of the corporation under Section 220"); *Scattered Corp.,* 701 A.2d at 78–79 ("[P]laintiffs inexplicably did not bring [a Section 220 action before filing their derivative complaint]. Accordingly, plaintiffs cannot argue that they have used the available 'tools at hand to obtain the necessary information before filing a derivative action.' " (quoting ***Grimes****,* 673 A.2d at 1216)); *Security First Corp. v. U.S. Die Casting & Dev. Co.,* 687 A.2d 563, 567 n. 3 (Del.1997) ("This Court has encouraged the use of Section 220 as an information-gathering tool in the derivative context, provided a proper purpose is shown." (internal quotation omitted)); *Rales,* 634 A.2d at 934 n. 10 (expressing surprise at the rarity with which Section 220 had been used to gather information to satisfy Court of Chancery Rule 23.1, and encouraging Court of Chancery to reward lawyers who use Section 220 before filing by appointing them lead counsel instead of the first-filers).

23 *See, e.g., Wood v. Baum,* 953 A.2d 136, 144 (Del.2008) (affirming dismissal of *Caremark* claim under Rule 23.1; noting that "plaintiff could have, but chose not to, make a 'books and records' request"); *In re Dow Chem. Co. Deriv. Litig.,* 2010 WL 66769, at *13 (Del.Ch. Jan. 11, 2010) (dismissing *Caremark* claim under Rule 23.1 where plaintiff did not use Section 220); *Desimone,* 924 A.2d at 951 (noting that plaintiff filed complaint with using Section 220 and therefore had "no idea what the [board's] investigation actually entailed and is unable to plead any facts about what the ... board did, when they did it, what they discussed, what conclusions they reached, and why the board did or did not do anything"); *Rattner v. Bidzos,* 2003 WL 22284323, at *14 (Del.Ch. Sept. 30, 2003) ("[A] symptomatic and ultimately fatal defect to all of Rattner's claims is a failure to plead facts with particularity.... [T]he books and records provisions of 8 *Del. C.* § 220 ... might have been helpful here...."); *In re Citigroup Inc. S'holders Litig.,* 2003 WL 21384599, at *3 (Del.Ch. June 5, 2003) ("Despite its prolixity, the

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Amended Complaint completely fails to set forth adequate reasons why demand is excused. Perhaps the absence of particularized facts excusing demand is the product of a race to the courthouse. It is certainly a result of the plaintiffs' failure to use the 'tools at hand' ...."), *aff'd sub nom. Rabinovitz v. Shapiro,* 839 A.2d 666 (Del.2003); *Guttman,* 823 A.2d at 493 ("Having failed to heed the numerous admonitions by our judiciary for derivative plaintiffs to obtain books and records before filing a complaint, the plaintiffs have unsurprisingly submitted an amended complaint that lacks particularized facts compromising the impartiality of the ... board that would have acted on a demand."); *id.* at 504 (noting that a § 220 action "could have provided the basis for the pleading of particularized facts"); *White v. Panic,* 793 A.2d 356, 371–72 (Del.Ch.2000) ("*White I*") (dismissing *Caremark* claim after noting that the plaintiff failed to use Section 220), *aff'd,* 783 A.2d 543 (Del.2001) ("*White II*").

24 *See, e.g., Wood,* 953 A.2d at 143 (rejecting assertion that a director "should have been on notice" about improper accounting or internal control issues due to his senior position at the company and membership on audit committee); *Hauspie v. Stonington P'rs, Inc.,* 945 A.2d 584, 587–88 (Del.2008) (rejecting argument that director must have known of financial misstatement because he served as a Managing Director and Vice Chairman); *Desimone,* 924 A.2d at 940 ("Delaware courts routinely reject the conclusory allegation that because illegal behavior occurred, internal controls must have been deficient, and the board must have known so.").

25 *Compare Ash v. McCall,* 2000 WL 1370341, at *16 (Del.Ch. Sept. 15, 2000) (dismissing *Caremark* claims without prejudice where plaintiff failed to use Section 220; noting that "if plaintiffs can allege with some particularity facts indicating that HBOC directors had actual knowledge of accounting irregularities, or knowledge of facts indicating potential accounting irregularities, and took no action until confronted with the DeLoitte audit report in early 1999 (after the merger), such facts, to my mind, could possibly excuse demand as to the Second Oversight Claim") *with Saito v. McCall,* 2004 WL 3029876, *7 (holding after stockholder used Section 220 that complaint challenging same transaction stated *Caremark* claim); *compare Brehm,* 746 A.2d at 266–67 (affirming Rule 23.1 dismissal of complaint for failure to plead particularized facts where plaintiff failed to use Section 220) *with In re The Walt Disney Co. Deriv. Litig.,* 825 A.2d 275, 287–90 (Del.Ch.2003) (holding after stockholder used Section 220 that complaint challenging same transaction survived Rule 23.1 motion).

26 *See Baca,* 2010 WL 2219715, at *5 (explaining why a rational stockholder plaintiff, "free of the compulsion to win a first-to-file sweepstakes," would not file a derivative action seeking to recover for corporate losses stemming from a restatement and related federal securities action "until after a ruling on a motion to dismiss the Federal Securities Action"); *King I,* 994 A.2d at 357 (noting "the lack of an investor-beneficial reason for urgent filing" in derivative suit where alleged damages were corporation's liability in underlying securities suit that had not yet been resolved).

27 *See, e.g., Brenner v. Albrecht,* 2012 WL 252286, at *7 (Del.Ch. Jan. 27, 2012) (staying derivative indemnification proceeding pending outcome of securities class action); *Brudno v. Wise,* 2003 WL 1874750, at *5 (Del.Ch. Apr. 1, 2003) (granting stay "[g]iven that the overwhelming thrust of the Delaware Action complaint is a demand for indemnification largely for harm to be incurred by [the corporation] in the Federal Securities Action, the sensible ordering of events is for the Federal Securities Action to proceed first"); *see also In re Massey Energy Co.,* 2011 WL 2176479, *27 (Del.Ch. May 31, 2011) ("[T]he plaintiffs, as fiduciaries for other Massey stockholders, [should] be reluctant to prosecute the Derivative Claims they claim are so valuable until the direct claims against Massey are resolved.... Thus, the Derivative Claims should follow, rather than precede, the resolution of the key direct suits and regulatory proceedings."); *Pfeiffer v. Toll,* 989 A.2d 683, 708 (Del.Ch.2010) (directing parties to confer where "[i]t would be counter-intuitive if an action such as this one, which exists to recover for harm imposed on the corporation, was permitted to proceed in a way that increased the burden on the corporation. At a minimum, sensible coordination with the Federal Securities Action is warranted. A stay ... also could make sense."), *abrogated on other grounds, Kahn v. Kohlberg Kravis Roberts & Co., L.P.,* 23 A.3d 831, 840 (Del.2011).

28 *See, e.g.,* Amir Efrati, *Madoff Trustee Sues Investors To Recover Funds,* Wall Street Journal, Apr. 10, 2009, http:// online.wsj. com/article/SB 123930717747706017.html?mg=com-wsj (reporting that Madoff trustee initiated "[w]hat will likely be a bitter, years-long battle" by filing first of numerous clawback suits on April 9, 2009, nearly four months after Madoff was arrested and his company forced into liquidation proceedings); Jacqueline Palank, *Trustee Sues Madoff Investors to Recover $187.5 Million,* Wall Street Journal, Jan. 13, 2012, http://online.wsj. com/article/SB 10001424052970204542404577158981083769316.html (reporting that Madoff trustee filed four lawsuits on January 12, 2012 that "are the latest of hundreds trying to recover money that Madoff fraudulently paid out to investors as part of the Ponzi scheme"); *see also* Azam Ahmed & Ben Protess, *Trustee Report Details Possible Claims Against Corzine and Others,* June 4, 2012, http://

dealbook.nytimes.com/2012/06/04/report-details-last-days-of-mf-global/ (reporting that court-appointed trustee issued 275–page report "based on interviews with more than 100 people and the review of hundreds of thousands of documents" concerning October 2011 collapse of brokerage firm MF Global); Jacqueline Palank, *Trustee Brings FBI, Accounting Experience to Solyndra Probe,* Mar. 27, 2012, http://blogs.wsj. com/ bankruptcy/2012/03/27/brings-fbi-accounting-experience-to-solyndra-probe/ (reporting that trustee "filed the results of his four-month-long investigation with the U.S. Bankruptcy Court in Wilmington, Del., which concludes that the now-liquidating Solyndra didn't mislead the Department of Energy about its financial health in connection with its $535 million federal loan guarantee").

29 *Cf.* Weiss & Beckerman, *supra,* at 2060 ("[T]he usual pattern is for a lawyer who specializes in representing plaintiffs to take the initiative. The lawyer typically becomes aware of a significant move in the price of a company's stock following disclosure of worse-than-expected earnings or other significant, unexpected information. She then conducts a brief investigation, generates a class action complaint, finds someone to serve as a 'representative' plaintiff, and files the complaint, often within a few days of the disclosure at issue."); Coffee, Jr., *Understanding the Plaintiff's Attorney, supra,* at 679 ("[B]ecause the attorney as private enforcer looks to the court, not the client, to award him a fee if successful, the attorney can find the legal violation first and the client second.").

30 Lawrence A. Hamermesh, *The Policy Foundations of Delaware Corporate Law,* 106 Colum. L.Rev. 1749, 1763–64 (2006) ("[T]oday's drafters of the DGCL do not devote an iota of conscious effort to make that statute more friendly to management and less protective of stockholders.... [W]e favor a much more conservative approach that seeks to maintain whatever balance currently exists, and we are distinctly uncomfortable with any change that alters that balance in either direction."); Leo E. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face,* 30 Del. J. Corp. L. 673, 680 (2005) ("[C]orporation law in Delaware is influenced by only the two constituencies whose views are most important in determining where entities incorporate: managers and stockholders.... [I]t is ... fair to say that both groups have a lot of clout, and that Delaware corporate lawmakers seriously consider each group's perspective on all key issues.... [T]he key takeaway point is that Delaware's financial self-interest in legal excellence leads to a productive dynamic for the creation and maintenance of an efficient and fair corporation law.").

31 *TCW Tech. Ltd. P'ship v. Intermedia Commc'ns, Inc.,* 2000 WL 1654504, at *3 (Del.Ch. Oct. 17, 2000) ("[N]one of the pending lawsuits in this litigation is entitled to any special status as the lead or coordinating lawsuit simply by virtue of having been filed earlier than any other pending action."); *id.* ("Although it might be thought, based on myths, fables, or mere urban legends, that the first to file a lawsuit in this Court wins some advantage in the race to represent the shareholder class, that assumption, in my opinion, has neither empirical nor logical support.... It is not the race to the courthouse door ... that impresses the members of this Court when it comes to deciding who should control and coordinate litigation on behalf of the shareholder class."); *see, e.g., In re Del Monte Foods Co. S'holders Litig.,* 2010 WL 5550677, at *6 (Del.Ch. Dec. 31, 2010) (choosing lead counsel based on a "nuanced and case-specific test in which the Court examines both the proposed lead counsel and the proposed named plaintiff," but not which complaint was filed first, because "[t]he Court's overriding goal is [to] establish a leadership structure that will provide effective representation"); *Wiehl v. Eon Labs,* 2005 WL 696764, at *1–3 (Del.Ch. Mar. 22, 2005) (appointing lead plaintiff and lead counsel by reference to various factors other than filing speed); *Hirt v. U.S. Timberlands Serv. Co.,* 2002 WL 1558342, at *2 (Del.Ch. July 3, 2002) (same); *TCW Tech.,* 2000 WL 1654504, at *4 (same).

32 *See King II,* 12 A.3d at 1150 ("[I]t is a proper purpose under Section 220 to inspect books and records that would aid the plaintiff in pleading demand futility in a to-be-amended complaint in a plenary derivative action, when the earlier-filed plenary complaint was dismissed on demand futility-related grounds without prejudice and with leave to amend."); *see also Amalgamated Bank v. NetApp, Inc.,* 2012 WL 379908, at *7 (Del.Ch. Feb. 6, 2012) (recognizing limitation of *King II* to without-prejudice dismissals in which stockholder-plaintiff could re-file). Because *King II* permits a derivative plaintiff to use Section 220 after a without-prejudice dismissal, Rule 15(aaa) now has the unfortunate side effect of encouraging plaintiffs to file derivative actions in courts that lack a similar rule and favor without-prejudice dismissals.

33 Others have embraced this view. *See, e.g.,* David L. Engel, *An Approach to Corporate Social Responsibility,* 32 Stan. L.Rev. 1, 34–55 (1979) (arguing that corporations can and should maximize profits by factoring in the cost of regulatory and legal sanctions discounted by likelihood of detection and successful enforcement); Frank H. Easterbrook & Daniel R. Fischel, *Antitrust Suits by Targets of Tender Offers,* 80 Mich. L.Rev. 1155,

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1168 n.36 (1982) (asserting that "[m]anagers have no general obligation to avoid violating regulatory laws, when violations are profitable to the firm."); *id.* at 1177 n. 57 (asserting that "managers do not have an ethical duty to obey economic regulatory laws just because the laws exist. They must determine the importance of these laws. The penalties Congress names for disobedience are a measure of how much it wants firms to sacrifice in order to adhere to the rules; the idea of optimal sanctions is based on the supposition that managers not only may but also should violate the rules when it is profitable to do so."). *See generally* Cynthia A. Williams, *Corporate Compliance With the Law In the Era of Efficiency,* 76 N.C. L.Rev. 1265, 1285–1300 (1998) (collecting and summarizing authorities endorsing the view of "law-as-price"). Delaware law explicitly rejects the notion that a board of directors can act loyally by consciously deciding to violate positive law in pursuit of greater profits. *See* Leo E. Strine, Jr. et al., *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law,* 98 Geo. L.J. 629, 649 (2010).

34 *See* Williams, *supra,* at 1279–80 ("[P]art of the calculation to violate the law includes a calculation of the probability that the violation will go undetected; or if detected, that it will go unprosecuted for any one of a plethora of reasons; or if prosecuted, that liability will not be established; or if liability is established, that the penalty will be lower than the profits obtained; or that the penalty will not be upheld on appeal in any event. Moreover, the probabilities at each of these stages can be, and in many cases will be, driven downward by actions by the corporation and the corporation's lawyers. So, although the theory may treat the question as one of violating a law deliberately and paying the penalty, the reality is that of risking paying a penalty at best." (alterations, footnote, and internal quotation omitted)).

35 *See, e.g., Massey Energy,* 2011 WL 2176479, at *19 ("Although the defendants point to a lot of motion by the independent directors, some of which resulted from a 2008 court-ordered settlement, the plaintiffs in turn point to evidence creating a plausible inference that the independent directors of Massey did just that—go through the motions—rather than make good faith efforts to ensure that Massey cleaned up its act."); *Saito,* 2004 WL 3029876, at *7 (denying Rule 23.1 motion to dismiss *Caremark* claims where "[p]laintiffs allege well-pled facts sufficient to infer that separately, both the HBOC and McKesson boards were aware (or should have been) of accounting irregularities at HBOC."); *cf. Am. Int'l Gp.,* 965 A.2d at 795 (drawing the "very plausible inference" that "those who engage in sophisticated forms of financial fraud do their best not to leave an obvious paper trail" but rather "try to conceal their roles and not leave marked paths leading to their doorsteps").

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West's Delaware Code Annotated
Title 8. Corporations
Chapter 1. General Corporation Law
Subchapter IV. Directors and Officers

8 Del.C. § 141

§ 141. Board of directors; powers; number, qualifications, terms and quorum; committees; classes of directors; nonstock corporations; reliance upon books; action without meeting; removal

Effective: August 1, 2016
Currentness

(a) The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation.

(b) The board of directors of a corporation shall consist of 1 or more members, each of whom shall be a natural person. The number of directors shall be fixed by, or in the manner provided in, the bylaws, unless the certificate of incorporation fixes the number of directors, in which case a change in the number of directors shall be made only by amendment of the certificate. Directors need not be stockholders unless so required by the certificate of incorporation or the bylaws. The certificate of incorporation or bylaws may prescribe other qualifications for directors. Each director shall hold office until such director's successor is elected and qualified or until such director's earlier resignation or removal. Any director may resign at any time upon notice given in writing or by electronic transmission to the corporation. A resignation is effective when the resignation is delivered unless the resignation specifies a later effective date or an effective date determined upon the happening of an event or events. A resignation which is conditioned upon the director failing to receive a specified vote for reelection as a director may provide that it is irrevocable. A majority of the total number of directors shall constitute a quorum for the transaction of business unless the certificate of incorporation or the bylaws require a greater number. Unless the certificate of incorporation provides otherwise, the bylaws may provide that a number less than a majority shall constitute a quorum which in no case shall be less than # of the total number of directors. The vote of the majority of the directors present at a meeting at which a quorum is present shall be the act of the board of directors unless the certificate of incorporation or the bylaws shall require a vote of a greater number.

(c)(1) All corporations incorporated prior to July 1, 1996, shall be governed by this paragraph (c)(1) of this section, provided that any such corporation may by a resolution adopted by a majority of the whole board elect to be governed by paragraph (c)(2) of this section, in which case this paragraph (c)(1) of this section shall not apply to such corporation. All corporations incorporated on or after July 1, 1996, shall be governed by paragraph (c)(2) of this section. The board of directors may, by resolution passed by a majority of the whole board, designate 1 or more committees, each committee to consist of 1 or more of the directors of the corporation. The board may designate 1 or more directors as alternate members of any committee, who may replace any absent or disqualified member at any meeting of the committee. The bylaws may provide that in the absence or disqualification of a member of a committee, the member or members present at any meeting

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and not disqualified from voting, whether or not the member or members present constitute a quorum, may unanimously appoint another member of the board of directors to act at the meeting in the place of any such absent or disqualified member. Any such committee, to the extent provided in the resolution of the board of directors, or in the bylaws of the corporation, shall have and may exercise all the powers and authority of the board of directors in the management of the business and affairs of the corporation, and may authorize the seal of the corporation to be affixed to all papers which may require it; but no such committee shall have the power or authority in reference to amending the certificate of incorporation (except that a committee may, to the extent authorized in the resolution or resolutions providing for the issuance of shares of stock adopted by the board of directors as provided in § 151(a) of this title, fix the designations and any of the preferences or rights of such shares relating to dividends, redemption, dissolution, any distribution of assets of the corporation or the conversion into, or the exchange of such shares for, shares of any other class or classes or any other series of the same or any other class or classes of stock of the corporation or fix the number of shares of any series of stock or authorize the increase or decrease of the shares of any series), adopting an agreement of merger or consolidation under § 251, § 252, § 254, § 255, § 256, § 257, § 258, § 263 or § 264 of this title, recommending to the stockholders the sale, lease or exchange of all or substantially all of the corporation's property and assets, recommending to the stockholders a dissolution of the corporation or a revocation of a dissolution, or amending the bylaws of the corporation; and, unless the resolution, bylaws or certificate of incorporation expressly so provides, no such committee shall have the power or authority to declare a dividend, to authorize the issuance of stock or to adopt a certificate of ownership and merger pursuant to § 253 of this title.

(2) The board of directors may designate 1 or more committees, each committee to consist of 1 or more of the directors of the corporation. The board may designate 1 or more directors as alternate members of any committee, who may replace any absent or disqualified member at any meeting of the committee. The bylaws may provide that in the absence or disqualification of a member of a committee, the member or members present at any meeting and not disqualified from voting, whether or not such member or members constitute a quorum, may unanimously appoint another member of the board of directors to act at the meeting in the place of any such absent or disqualified member. Any such committee, to the extent provided in the resolution of the board of directors, or in the bylaws of the corporation, shall have and may exercise all the powers and authority of the board of directors in the management of the business and affairs of the corporation, and may authorize the seal of the corporation to be affixed to all papers which may require it; but no such committee shall have the power or authority in reference to the following matter: (i) approving or adopting, or recommending to the stockholders, any action or matter (other than the election or removal of directors) expressly required by this chapter to be submitted to stockholders for approval or (ii) adopting, amending or repealing any bylaw of the corporation.

(3) Unless otherwise provided in the certificate of incorporation, the bylaws or the resolution of the board of directors designating the committee, a committee may create 1 or more subcommittees, each subcommittee to consist of 1 or more members of the committee, and delegate to a subcommittee any or all of the powers and authority of the committee. Except for references to committees and members of committees in subsection (c) of this section, every reference in this chapter to a committee of the board of directors or a member of a committee shall be deemed to include a reference to a subcommittee or member of a subcommittee.

(4) A majority of the directors then serving on a committee of the board of directors or on a subcommittee of a committee shall constitute a quorum for the transaction of business by the committee or subcommittee, unless the certificate of incorporation, the bylaws, a resolution of the board of directors

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or a resolution of a committee that created the subcommittee requires a greater or lesser number, provided that in no case shall a quorum be less than # of the directors then serving on the committee or subcommittee. The vote of the majority of the members of a committee or subcommittee present at a meeting at which a quorum is present shall be the act of the committee or subcommittee, unless the certificate of incorporation, the bylaws, a resolution of the board of directors or a resolution of a committee that created the subcommittee requires a greater number.

(d) The directors of any corporation organized under this chapter may, by the certificate of incorporation or by an initial bylaw, or by a bylaw adopted by a vote of the stockholders, be divided into 1, 2 or 3 classes; the term of office of those of the first class to expire at the first annual meeting held after such classification becomes effective; of the second class 1 year thereafter; of the third class 2 years thereafter; and at each annual election held after such classification becomes effective, directors shall be chosen for a full term, as the case may be, to succeed those whose terms expire. The certificate of incorporation or bylaw provision dividing the directors into classes may authorize the board of directors to assign members of the board already in office to such classes at the time such classification becomes effective. The certificate of incorporation may confer upon holders of any class or series of stock the right to elect 1 or more directors who shall serve for such term, and have such voting powers as shall be stated in the certificate of incorporation. The terms of office and voting powers of the directors elected separately by the holders of any class or series of stock may be greater than or less than those of any other director or class of directors. In addition, the certificate of incorporation may confer upon 1 or more directors, whether or not elected separately by the holders of any class or series of stock, voting powers greater than or less than those of other directors. Any such provision conferring greater or lesser voting power shall apply to voting in any committee, unless otherwise provided in the certificate of incorporation or bylaws. If the certificate of incorporation provides that 1 or more directors shall have more or less than 1 vote per director on any matter, every reference in this chapter to a majority or other proportion of the directors shall refer to a majority or other proportion of the votes of the directors.

(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 the records of the corporation and 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.

(f) Unless otherwise restricted by the certificate of incorporation or bylaws, any action required or permitted to be taken at any meeting of the board of directors or of any committee thereof may be taken without a meeting if all members of the board or committee, as the case may be, consent thereto in writing, or by electronic transmission and the writing or writings or electronic transmission or transmissions are filed with the minutes of proceedings of the board, or committee. Such filing shall be in paper form if the minutes are maintained in paper form and shall be in electronic form if the minutes are maintained in electronic form. Any person (whether or not then a director) may provide, whether through instruction to an agent or otherwise, that a consent to action will be effective at a future time (including a time determined upon the happening of an event), no later than 60 days after such instruction is given or such provision is made and such consent shall be deemed to have been given for purposes of this subsection at such effective time so long as such person is then a director and did not revoke the consent prior to such time. Any such consent shall be revocable prior to its becoming effective.

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(g) Unless otherwise restricted by the certificate of incorporation or bylaws, the board of directors of any corporation organized under this chapter may hold its meetings, and have an office or offices, outside of this State.

(h) Unless otherwise restricted by the certificate of incorporation or bylaws, the board of directors shall have the authority to fix the compensation of directors.

(i) Unless otherwise restricted by the certificate of incorporation or bylaws, members of the board of directors of any corporation, or any committee designated by the board, may participate in a meeting of such board, or committee by means of conference telephone or other communications equipment by means of which all persons participating in the meeting can hear each other, and participation in a meeting pursuant to this subsection shall constitute presence in person at the meeting.

(j) The certificate of incorporation of any nonstock corporation may provide that less than 1/3 of the members of the governing body may constitute a quorum thereof and may otherwise provide that the business and affairs of the corporation shall be managed in a manner different from that provided in this section. Except as may be otherwise provided by the certificate of incorporation, this section shall apply to such a corporation, and when so applied, all references to the board of directors, to members thereof, and to stockholders shall be deemed to refer to the governing body of the corporation, the members thereof and the members of the corporation, respectively; and all references to stock, capital stock, or shares thereof shall be deemed to refer to memberships of a nonprofit nonstock corporation and to membership interests of any other nonstock corporation.

(k) Any director or the entire board of directors may be removed, with or without cause, by the holders of a majority of the shares then entitled to vote at an election of directors, except as follows:

(1) Unless the certificate of incorporation otherwise provides, in the case of a corporation whose board is classified as provided in subsection (d) of this section, stockholders may effect such removal only for cause; or

(2) In the case of a corporation having cumulative voting, if less than the entire board is to be removed, no director may be removed without cause if the votes cast against such director's removal would be sufficient to elect such director if then cumulatively voted at an election of the entire board of directors, or, if there be classes of directors, at an election of the class of directors of which such director is a part.

Whenever the holders of any class or series are entitled to elect 1 or more directors by the certificate of incorporation, this subsection shall apply, in respect to the removal without cause of a director or directors so elected, to the vote of the holders of the outstanding shares of that class or series and not to the vote of the outstanding shares as a whole.

Credits

56 Laws 1967, ch. 50; 56 Laws 1967, ch. 186, § 3; 57 Laws 1969, ch. 148, §§ 5, 6; 57 Laws 1970, ch. 421, § 1; 59 Laws 1974, ch. 437, §§ 2-5; 64 Laws 1983, ch. 112, § 6; 65 Laws 1985, ch. 127, § 3; 66 Laws 1987, ch. 136, §§

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2, 3; 70 Laws 1995, ch. 79, § 7, eff. July 1, 1995; 70 Laws 1995, ch. 186, § 1, eff. July 10, 1995; 70 Laws 1996, ch. 349, § 2, eff. July 1, 1996; 71 Laws 1998, ch. 339, §§ 11-13, eff. July 1, 1998; 72 Laws 2000, ch. 343, §§ 4-6, eff. July 1, 2000; 73 Laws 2002, ch. 298, § 2, eff. July 1, 2002; 74 Laws 2003, ch. 84, § 2, eff. Aug. 1, 2003; 74 Laws 2004, ch. 326, § 2, eff. Aug. 1, 2004; 75 Laws 2005, ch. 30, § 1, eff. Aug. 1, 2005; 75 Laws 2006, ch. 306, §§ 3, 4, eff. Aug. 1, 2006; 76 Laws 2007, ch. 145, § 1, eff. Aug. 1, 2007; 77 Laws 2010, ch. 253, §§ 10-12, eff. Aug. 1, 2010; 79 Laws 2014, ch. 327, § 3, eff. Aug. 1, 2014; 80 Laws 2016, ch. 265, §§ 3 to 5, eff. Aug. 1, 2016.

Codifications: 8 Del.C. 1953, § 141

Editors' Notes

Relevant Additional Resources

Additional Resources listed below contain your search terms.

LAW REVIEW AND JOURNAL COMMENTARIES

Aronson v. Lewis: When Demand is Excused and Delaware's Business Judgment Rule. **Donald** E. Pease, 9 Del. J. Corp. L. 39 (1984).

Relevant Notes of Decisions (9)

View all 1823

Notes of Decisions listed below contain your search terms.

IN GENERAL

Issue of stock certificates

Statutory provisions of the Corporation Law, setting forth the principle that the business and affairs of a corporation are to be managed by and under the direction of the board of directors, and relating to the issuance of capital stock, subscriptions, options and rights agreements, together are calculated to advance two fundamental policies of the Corporation Law: (1) to consolidate in its board of directors the exclusive authority to govern and regulate a corporation's capital structure, and (2) to ensure certainty in the instruments upon which the corporation's capital structure is based. 8 Del.C. §§ 141(a), 151-153, 157, 161, 166. **Grimes** v. Alteon, Inc., 804 A.2d 256 (2002). Corporations And Business Organizations 1378

OFFICER RIGHTS, DUTIES AND LIABILITIES

Compensation, officer rights, duties and liabilities

Board of directors had not abdicated its ability to manage or direct management of corporation by entering into employment agreements with chief executive officer (CEO) allowing CEO to unilaterally declare contract terminated without cause if board unreasonably interfered with his management of corporation, triggering right of CEO to obtain severance benefits of up to $20 million; considering size of corporation $20 million was not so prohibitive as to mandate conclusion that board had de facto abdicated its management role, on grounds that termination would be so costly that board would not in fact supervise CEO, and present marketplace for CEO required grant of substantial benefits to attract qualified persons. **Grimes** v. **Donald**, 1996, 673 A.2d 1207. Corporations And Business Organizations 1819(1)

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Actions between shareholders and officers or agents, officer rights, duties and liabilities--In general

Pleading requirements for making a direct claim by shareholder against board of directors may be satisfied by a "short and plain statement of the claim." Chancery Court Rule 12(b)(6). **Grimes** v. **Donald**, 1996, 673 A.2d 1207. Corporations And Business Organizations 1937(2)

---- Failure of action by corporation and demand that action be brought, actions between shareholders and officers or agents, officer rights, duties and liabilities

Stockholder who had made demand on board of directors that it abrogate employment contracts with chief executive officer (CEO), on grounds that agreements had effect of abdicating responsibility of board to manage corporation, could not subsequently claim that he was excused from demanding that board abrogate agreements on grounds that they constituted corporate waste and involved excessive compensation. **Grimes** v. **Donald**, 1996, 673 A.2d 1207. Corporations And Business Organizations 2090(1)

Review, officer rights, duties and liabilities

Supreme Court reviews de novo decision by Court of Chancery on motion to dismiss claim brought directly against board of directors by shareholder, applying same legal standard as used by Court of Chancery. Chancery Court Rule 12(b)(6). **Grimes** v. **Donald**, 1996, 673 A.2d 1207. Appeal And Error 3200

SHAREHOLDERS AND MEMBERS GENERALLY

---- Refusal of corporation, officers or stockholders to act, suing or defending on behalf of corporation, shareholders and members generally

Stockholder who makes demand that board of directors institute suit on behalf of corporation is entitled to know promptly what action board has taken in response to demand. **Grimes** v. **Donald**, 1996, 673 A.2d 1207. Corporations And Business Organizations 2039(1)

Stockholder who makes serious demand on board of directors that it institutes suit on behalf of corporation and receives only peremptory refusal has right to use "tools at hand," including public information, and stockholder's right to inspect corporate books and records, to determine whether or not there is basis to assert that demand was wrongfully refused. 8 Del.C. § 220. **Grimes** v. **Donald**, 1996, 673 A.2d 1207. Corporations And Business Organizations 2039(1)

Stockholder will be excused from requirement that demand be made on board of directors before instituting suit on behalf of corporation when (1) majority of board has material financial or familial interest in matter in question, (2) majority of board is incapable of acting independently for some other reason such as domination or control, or (3) underlying transaction is not product of valid exercise of business judgment. **Grimes** v. **Donald**, 1996, 673 A.2d 1207. Corporations And Business Organizations 2040(1); Corporations And Business Organizations 2040(2)

---- Evidence, suing or defending on behalf of corporation, shareholders and members generally

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If demand is made by stockholder on board of directors, that board bring action on behalf of corporation, and board rejects demand, board is entitled to presumption of business judgment rule unless stockholder can allege facts with particularity creating reasonable doubt that board is entitled to benefit of presumption. **Grimes** v. **Donald**, 1996, 673 A.2d 1207. Corporations And Business Organizations 2057

8 Del.C. § 141, DE ST TI 8 § 141
Current through ch. 9 of the 150th General Assembly (2019-2020). Some statute sections may be more current, see credits for details. Revisions to 2019 Acts by the Delaware Code Revisors were unavailable at the time of publication.

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N.J.A.C. Executive Order No. 26(2005)

Executive Order No. 26(2005)Tribute to United States Army Captain Sean **Grimes**

Currentness

Issued: March 14, 2005.

Effective: March 14, 2005.

WHEREAS, United States Army Captain Sean **Grimes**, the beloved son of Mary **Grimes** of Dover, New Jersey, and **Donald** P. **Grimes** of Southfield, Michigan, graduated from Michigan State University, with a B.S. degree in nursing; and

WHEREAS, Captain **Grimes** enlisted in the U.S. Army in 1997 and served as a physician's assistant and an Army nurse; and

WHEREAS, Captain **Grimes** graduated from the Army's Air Assault Course and from the Army's Airborne School; and

WHEREAS, Captain **Grimes** proudly served as a member of the U.S. Army's 1st Infantry Battalion, 9th Infantry Regiment, 2nd Brigade Combat Team, and was deployed to Iraq in the service of his country; and

WHEREAS, Captain **Grimes** was a courageous soldier, and a loving son and brother; and

WHEREAS, Captain **Grimes** has made the ultimate sacrifice, giving his life in the line of duty while serving our nation, and has been awarded the Purple Heart, the Bronze Star, and the Combat Medic Badge posthumously; and

WHEREAS, Captain **Grimes**' patriotism and dedicated service to his country make him a hero and a true role model for all Americans and, therefore, it is appropriate and fitting for the State of New Jersey to mark his passing and to honor his memory;

NOW, THEREFORE, I, RICHARD J. CODEY, Acting Governor of the State of New Jersey, by virtue of the authority vested in me by the Constitution and by the Statutes of this State, do hereby ORDER and DIRECT:

1. The flag of the United States of America and the flag of New Jersey shall be flown at half-staff at all State departments, offices, agencies and instrumentalities during appropriate hours on Tuesday, March 15, 2005, in recognition and mourning of United States Army Captain Sean **Grimes**.

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2. This Order shall take effect immediately.

Credits

Published April 18, 2005 in the New Jersey Register at 1107(a).

Current through amendments included in the New Jersey Register, Volume 51, Issue 8, dated April 15, 2019.

N.J.A.C. No. 26(2005), NJ ADC EX. ORD. No. 26(2005)

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5 FPSC 262, 1979 WL 404133 (Fla.P.S.C.)

In Re: Donald Harvey Grimes, d/b/a D. H. Grimes Livestock Hauling. For-Hire Permit No. 2665.

Docket No. 770535-FH (CX)
Order No. 14974

Florida Public Service Commission

January 24, 1979

Before Robert T. Mann, Chairman, William T. Mayo, Paula F. Hawkins, Gerald L. Gunter and Joseph P. Cresse, Commissioners.

ORDER CANCELLING PERMIT

BY THE COMMISSION:

By letter dated November 5, 1978, D. H. Grimes has requested cancellation of Permit No. 2665 as he is no longer in business. We find the request to be reasonable. It is, therefore,

ORDERED by the Florida Public Service Commission, that For-Hire Permit No. 2665 be and the same is hereby cancelled.

By Order of Chairman ROBERT T. MANN, Commissioner WILLIAM T. MAYO, Commissioner PAULA F. HAWKINS, Commissioner GERALD L. GUNTER and Commissioner JOSEPH P. CRESSE, as and constituting the Florida Public Service Commission, this 24th day of January, 1979.

As printed in Florida Public Service Commission Reporter

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Shareholder Derivative Litigation

BY JOSEPH M. MCLAUGHLIN, SIMPSON THACHER & BARTLETT LLP, WITH PRACTICAL LAW LITIGATION

A Practice Note examining the unique features of shareholder derivative lawsuits. Specifically, this Note addresses the basic issues raised by shareholder derivative lawsuits, how to choose the right plaintiff to bring a shareholder derivative lawsuit, the requirement of a pre-suit demand on the board of directors, how to litigate a shareholder derivative lawsuit, settling a shareholder derivative lawsuit, the ability to request security for costs associated with shareholder derivative litigation, and the remedies available in shareholder derivative litigation.

A shareholder derivative lawsuit is a type of lawsuit a shareholder brings on behalf of a corporation against that corporation's management or **board of directors** to remedy alleged misconduct by the directors or managers. This Note examines shareholder derivative lawsuits by analyzing:

- Basic issues raised by shareholder derivative lawsuits.
- How to choose the right plaintiff to bring a shareholder derivative lawsuit.
- The requirement of a pre-suit demand on a board of directors.
- How to litigate a shareholder derivative lawsuit.
- Settling a shareholder derivative lawsuit.
- The ability to request security for costs.
- The remedies available in shareholder derivative litigation.

Basic Issues

Shareholder derivative lawsuits provide shareholders a means to address wrongs to corporations. The basic issues of shareholder derivative litigation include:

- What a shareholder derivative lawsuit is (see Defining a Shareholder Derivative Lawsuit).
- Who the parties to a shareholder derivative lawsuit are (see Parties in a Shareholder Derivative Lawsuit).
- What claims are made in a shareholder derivative lawsuit (see Types of Claims Made in a Shareholder Derivative Lawsuit).
- What happens when a shareholder derivative plaintiff wins (see Next Steps if Plaintiff Wins).
- The distinction between derivative and direct lawsuits (see Distinction between Derivative and Direct Lawsuits).

Defining a Shareholder Derivative Lawsuit

A shareholder derivative action is a suit that shareholders assert on behalf of a corporation against those liable to the corporation (*In re Ezcorp Inc. Consulting Agreement Deriv. Litig.*, 130 A.3d 934, 944 (Del. Ch. 2016)).

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While this Note only addresses derivative lawsuits brought by shareholders of a corporation, **members** or assignees of **limited liability companies** and **partners** in **partnerships** may also bring derivative lawsuits (for example, 6 Del. C. § 18-1002; 6 Del. C. § 17-1002).

Parties in a Shareholder Derivative Lawsuit

The plaintiff listed in a shareholder derivative lawsuit is an owner of shares in a corporation who brings the action on behalf of the corporation for injuries to the corporation (see *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 528 (1984)). The defendants in a lawsuit generally include officers or directors of the corporation or other corporate insiders.

Although a shareholder brings the action, the claims asserted in a derivative lawsuit actually belong to the corporation (*In re MAXXAM, Inc./Federated Dev. S'holders Litig.*, 698 A.2d 949, 956 (Del. Ch. 1996)). The corporation is an indispensable party to a shareholder derivative lawsuit and receives any damages awarded (*Sternberg v. O'Neil*, 550 A.2d 1105, 1124 (Del. 1988), abrogated on other grounds by, *Genuine Parts Co. v. Cepec*, 137 A.3d 123 (Del. 2016); *Agostino v. Hicks*, 845 A.2d 1110, 1116 n.15 (Del. Ch. 2004)). Therefore, while shareholder plaintiffs list the corporation as a nominal defendant in a derivative lawsuit, courts may align the corporation with the plaintiff provided that the corporation is not antagonistic to the shareholder's interests (*In re Digimarc Corp. Deriv. Litig.*, 549 F.3d 1223, 1234 (9th Cir. 2008)).

Types of Claims Made in a Shareholder Derivative Lawsuit

Often, the plaintiff bringing a shareholder derivative lawsuit alleges that the corporation's directors and/or officers breached a **fiduciary duty** owed to the corporation and shareholders. The basic issues relating to a claim for breach of fiduciary duty include:

- Types of fiduciary duties owed to the corporation and shareholders (see Types of Duties Owed to the Corporation).
- Defense to a claim of breach of fiduciary duty (see Defense to a Claim for Breach of Duty of Care).

Types of Fiduciary Duties Owed to the Corporation

Directors or officers owe two main fiduciary duties to the corporation and shareholders:

- **The duty of care.** This requires directors or officers to use the same amount of care which an ordinarily careful and prudent person would use in similar circumstances.
- **The duty of loyalty.** This requires directors or officers to act in good faith for the benefit of the corporation and its shareholders rather than for their own interest.

(*In re Walt Disney Co. Deriv. Litig.*, 907 A.2d 693, 745 (Del. Ch. 2005).)

Corporate acts that may constitute a breach of fiduciary duty include:

- Realizing illegal profits.
- Excessive executive compensation.
- Fraud.
- Mismanagement.

For a detailed discussion of fiduciary duties, see Practice Note, Fiduciary Duties of the Board of Directors.

Directors may have many other duties stemming from the corporation's charter documents, ethics policies, stock exchange (if a public company), or the SEC (see Practice Note, Corporate Governance Standards: Board of Directors).

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Defense to a Claim for Breach of the Duty of Care

Directors' actions are generally protected by the business judgment rule (see *Zapata Corp. v. Maldonado*, 430 A.2d 779, 782 (Del. 1981)). The rule presumes the board of directors acted on an informed basis and in the honest belief that the action was taken in the best interest of the corporation (*Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), overruled on other grounds by *Brehm v. Eisner*, 746 A.2d 244, 253-54 (Del. 2000)). In a lawsuit alleging a breach of the duty of care, the court presumes the directors exercised proper business judgment unless the plaintiffs can show the directors did not meet three elements:

- **Informed.** The director must keep informed about the corporation and its decisions. Directors should be made aware that they must participate in board actions. This means attending meetings (in person or by phone), carefully reading reports or other materials, and asking questions. Directors can rely on information and opinions from consultants, management, and employees, but must make their own good faith determination that those persons can competently produce the reports and make the analysis on which the board relies (8 Del C. § 141(e)). Directors sometimes serve on multiple corporate boards, but must be careful not to spread themselves too thin or risk breaching the duty of care.
- **Good faith.** The directors must act in good faith. The decision-making process must be substantive and cannot just rubber stamp management's actions.
- **Best interest of the corporation.** The directors must reasonably believe the action or transaction was taken in the best interest of the corporation. A director with a conflict of interest triggers the duty of loyalty, and as a result, the business judgment rule no longer applies.

For information about the business judgment rule, see Practice Note, Fiduciary Duties of the Board of Directors: Business Judgment Rule.

Defense to Claims Against Third Parties

Some derivative claims do not allege a breach of fiduciary duty on the part of the corporation's directors or officers, but instead allege claims against non-fiduciaries of the corporation. Examples of these claims include breach of contract, negligence, or aiding and abetting a breach of fiduciary duty. These claims may be subject to the defense of *in pari delicto*.

The doctrine of *in pari delicto* is an **affirmative defense** that bars a party from recovering damages if its losses are substantially caused by its own forbidden actions (*In re Am. Int'l Gp., Inc., Consol. Deriv. Litig.*, 976 A.2d 872, 883 (Del. Ch. 2009) (*AIG II*)). The purpose of the doctrine is to deter wrongful conduct by refusing wrongdoers any relief, and to protect the judicial system from having to use its resources to provide an accounting of blame among wrongdoers (*AIG II*, 976 A.2d at 882, n.21). Because the knowledge and actions of a corporation's officers and directors, acting within the scope of their authority, are imputed to the corporation itself, *in pari delicto* should theoretically bar any recovery for shareholders who bring a derivative action alleging wrongdoing by those individuals. This is because any wrongdoing committed by a director or officer is legally considered to have been committed by the corporation itself, which means that in a derivative action, the corporation effectively seeks recovery for wrongdoing that it itself has participated in committing. To avoid leaving no possibility of recovery for shareholders in derivative actions, the law has developed three recognized exceptions to the doctrine of *in pari delicto*:

- **Adverse interest.** Where the director or officer responsible for the wrongdoing was acting solely to advance his own personal financial interest, rather than that of the corporation itself, the shareholders can recover (*AIG II*, 976 A.2d at 891). If the director or officer solely owns or otherwise dominates the corporation, this exception is virtually always unavailable, because the distinction between principal and agent disappears (*Stewart v. Wilmington Trust SP Servs., Inc.*, 112 A.3d 271, 311 (Del. Ch. 2015)), *aff'd*, 126 A.3d 1115 (Del. 2015).

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- **Fiduciary duty.** The doctrine has no force in a suit by a corporation against its own fiduciaries (*AIG II*, 976 A.2d at 876, 889-95). This exception is what allows derivative actions against the corporation's own directors and officers alleging a breach of fiduciary duty. Without it, all derivative actions alleging a breach of fiduciary duty would be impossible.
- **Public policy.** The defense is unavailable when another public policy is perceived to trump the policy basis for the doctrine (*AIG II*, 976 A.2d at 888). For example, some courts have created specific exceptions from *in pari delicto* to allow derivative claims against auditors to proceed under certain circumstances (see *NCP Litig. Trust v. KPMG LLP*, 901 A.2d 871, 882-83 (N.J. 2006); *Official Comm. of Unsecured Creditors of Allegheny Health Educ. & Research Found. v. PricewaterhouseCoopers, LLP*, 989 A.2d 313 (Pa. 2010)). The Delaware judiciary has not gone as far as to apply a blanket exception for auditors, but has ruled that a public policy exception is available for claims brought against auditors alleging aiding and abetting a breach of fiduciary duty by the corporation's fiduciaries (*Stewart*, 112 A.3d at 319, aff'd, 126 A.3d 1115).

Because the adverse interest and fiduciary duty exceptions do not apply to claims against non-fiduciaries, a derivative claim against a third party will often be barred by the doctrine of *in pari delicto* (absent a separate public policy consideration). In this regard, the courts have explicitly rejected the argument that it is unjust for "innocent" stockholders, who themselves have done nothing wrong, to be unable to recoup their losses. In a derivative claim, the stockholders stand in the shoes of the corporation, and a corporation that has participated in the wrongdoing cannot overcome *in pari delicto* without a recognized exception (*AIG II*, 976 A.2d at 889).

Next Steps if Plaintiff Wins

If the plaintiff successfully prosecutes a derivative lawsuit:

- The defendants may be required to pay compensatory and **punitive damages** that go to the corporation (*Kalin v. Xanboo, Inc.*, 526 F.Supp.2d 392, 407 (S.D.N.Y. 2007)).
- The corporation may be entitled to equitable relief for the corporation, such as an **injunction** or declaratory relief (*Kalin*, 526 F.Supp.2d, at 408).
- Plaintiff's counsel may be able to recover their attorneys' fees from the defendants (see Attorneys' Fees in Shareholder Derivative Litigation).

Distinction between Derivative and Direct Lawsuits

Courts have had difficulty distinguishing derivative and direct lawsuits brought by shareholders primarily because both lawsuits may arise from the same set of facts (see, for example, ***Grimes v. Donald***, 673 A.2d 1207, 1212 (Del. 1996), overruled on other grounds by *Brehm*, 746 A.2d at 254). The distinction between the two types of suit may be determined by examining:

- The legal distinction between derivative and direct lawsuits (see Legal Distinction between Derivative and Direct Lawsuits).
- Examples of derivative and **direct claims** (see Examples of Derivative and Direct Claims).
- The significance of the distinction (see Significance of Distinction between Derivative and Direct Lawsuits).

Legal Distinction between Derivative and Direct Lawsuits

There is a legal distinction between a derivative and direct lawsuit:

- In a derivative lawsuit, the shareholder asserts claims that belong to the corporation on behalf of the corporation.
- In a direct lawsuit, the shareholder asserts a claim for harm done to the individual shareholder.

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(See *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 548 (1949); *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1036 (Del. 2004).)

In *Tooley*, the Delaware Supreme Court articulated how to distinguish direct and derivative claims through a two-part test:

- Who suffered the alleged harm (the corporation or the suing stockholders, individually)?
- Who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?

Examples of Derivative and Direct Claims

Courts have found a plaintiff's claims to be derivative in nature when:

- Plaintiff's claim for waste, which concerned a targeted company's directors awarding its management excessive compensation after a **merger**, did not affect the individual contractual rights of shareholders (*Kramer v. W. Pac. Indus., Inc.*, 546 A.2d 348, 351 (Del. 1988)).
- Under the same theory of waste as in *Kramer*, the company entered into an award agreement with its chief executive officer that would grant the CEO improper change-of-control payments (*In re Ebix, Inc. S'holder Litig.*, 2014 WL 3696655, at *15 (Del. Ch. July 24, 2014)).
- A board member rejected a merger with another organization after failing to secure a post-merger position and failed to inform his fellow directors. This amounted to a claim that the board member acted only to secure a future position for himself at the expense of the corporation (otherwise known as an entrenchment claim) (*In re NYMEX S'holder Litig.*, 2009 WL 3206051, at *9 (Del. Ch. Sept. 30, 2009)).

Courts have found a plaintiff's claims to be direct in nature when:

- The shareholder seeks to enforce its rights under the corporation's **certificate of incorporation** or **by-laws**, such as the right to vote and the right to compel payment of a contractually specified **dividend** (*In re Activision Blizzard, Inc. S'holder Litig.*, 124 A.3d 1025, 1049-50 (Del. Ch. 2015). Similarly, an **LLC** member's claim to enforce payment of **distributions** in the priority set out in the company's **LLC agreement** is treated as a direct claim (*CMS Inv. Hldgs. v. Castle*, 2015 WL 3894021, at *8 (Del. Ch. Jun. 23, 2015)).
- The shareholder seeks to enforce its own contractual right against the defendant, even when the corporation in which the plaintiff owns stock is a third-party beneficiary of the contract and the plaintiff's loss derives from the loss suffered by the corporation (*NAF Hldgs., LLC v. Li & Fung (Trading) Ltd.*, 118 A.3d 175, 181 (Del. 2015)).
- The board of directors implemented a rights plan that deterred and prevented a **proxy contest** to replace the incumbent board resulting in the direct impairment of shareholders' voting rights (*Carmody v. Toll Bros., Inc.*, 723 A.2d 1180, 1189 (Del. Ch. 1998)).
- The chief executive officer of a company demanded unreasonable payments and asset transfers from a potential acquirer in exchange for his approval of any proposed merger, which may have resulted in a lower stock purchase price directly affecting the shareholders (*Parnes v. Bally Entm't Corp.*, 722 A.2d 1243, 1245 (Del. 1999)).
- The company made material misstatements or omissions in a **proxy statement** that impaired the stockholders' right to cast an informed vote (*In re J.P. Morgan Chase & Co. S'holder Litig.*, 906 A.2d 766, 772 (Del. 2006); *In re Tyson Foods, Inc. Consol. S'holder Litig.*, 919 A.2d 563, 601 (Del. Ch. 2007); *In re Ebix, Inc.*, 2014 WL 3696655, at *16).

Generally, harm to the corporation or to all stockholders pro rata in proportion with their ownership gives rise to a derivative claim. Conversely, harm to the stockholders independent of any harm to the corporation gives rise to a direct claim. However, the Delaware courts

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have recognized that certain types of corporate-overpayment claims can be categorized as both direct and derivative. If a controlling stockholder expropriates value to itself by, for example, causing the corporation to issue more stock to the controller than was contractually owed, then both the corporation and the minority stockholders have been harmed (*Gentile v. Rossette*, 906 A.2d 91 (Del. 2006)). The corporation is harmed because it has issued more stock than it should have; it has a derivative claim to restore the value of the overpayment. The minority shareholders are also harmed because the size of their ownership stake in the corporation has been unfairly **diluted**. Therefore, they have a direct claim.

The Delaware Court of Chancery has held that the ruling in *Gentile v. Rossette* can also be applied when there was no single controlling shareholder that committed the expropriation. The minority shareholders' claim can be characterized as direct if either:

- A group of stockholders formed a control group through a legally significant connection, such as contract, common ownership, agreement, or other arrangement, and were working together toward a shared goal (*Dubroff v. Wren Hldgs., LLC,* 2009 WL 1478697, at *3 (Del. Ch. May 22, 2009)).
- A majority of the members of the board had a conflict of interest in the disputed transaction (*Carsanaro v. Bloodhound Tech., Inc.*, 65 A.3d 618, 658 (Del. Ch. 2013); *In re Nine Sys. Corp. S'holders Litig.*, 2014 WL 4383127, at *29 (Del. Ch. Sept. 4, 2014)).

Another difficulty arises when determining whether a challenge against an unreasonable anti-takeover device is a direct or derivative claim. However, the Delaware Court of Chancery in *Gaylord Container* explained that this issue can largely be avoided if the claim implicates the *Unocal* enhanced scrutiny standard (see Practice Note, Fiduciary Duties of the Board of Directors: Defensive Measures). By this rationale, if the claim is derivative, then demand is excused because of the specter of a conflict of interest, while if the claim is direct, then no demand was ever necessary (*In re Gaylord Container Corp. S'holders Litig.*, 747 A.2d 71, 81 (Del. Ch. 1999)).

Significance of Distinction between Derivative and Direct Lawsuits

Classifying lawsuits as derivative or direct is significant because:

- Derivative lawsuits are subject to heightened pleading standards, requiring plaintiffs to plead facts sufficient to satisfy the standing and demand requirements, while direct lawsuits are usually subject to lower notice pleading standards (*MCG Capital Corp. v. Maginn*, 2010 WL 1782271, at *4 (Del. Ch. Mar. 5, 2010)) (also see Choosing the Right Plaintiff to Bring a Shareholder Derivative Lawsuit and Pre-Suit Demand on the Board).
- Shareholders must make a pre-suit demand on the board to take an action before bringing a shareholder derivative lawsuit, but not before bringing a direct lawsuit (*Ruffalo v. Transtech Service P'rs Inc.,* 2010 WL 3307487 (Del. Ch. Aug. 23, 2010)) (also see Pre-Suit Demand on the Board).
- Shareholders are not entitled to money damages in derivative lawsuits, but may obtain these damages in direct lawsuits (*Schultz v. Ginsburg*, 965 A.2d 661, 668 (Del. 2009)).
- In states with a contemporaneous ownership requirement, shareholders only have standing to bring a derivative action if they were shareholders at the time of the challenged transaction and continue to be shareholders throughout the litigation (see Plaintiff Must Be a Shareholder Throughout the Litigation). Direct claims, by contrast, are transferrable from the shareholder who suffered a loss at the time of the transaction to a new shareholder (*Schultz v. Ginsburg*, 965 A.2d at 667).
- Derivative claims against a company are extinguished in a merger of that company (see Effect of Merger on Plaintiff's Standing).

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- Plaintiffs are entitled to only limited discovery in shareholder derivative lawsuits (see Limited Discovery Available in Shareholder Derivative Lawsuits).

Choosing the Right Plaintiff to Bring a Shareholder Derivative Lawsuit

The plaintiff in a shareholder derivative lawsuit must meet certain requirements to have the ability to bring the lawsuit. Shareholder derivative plaintiffs must:

- Have standing to sue (see Plaintiff Must Have Standing to Sue).
- Adequately represent the other shareholders (see Plaintiffs Must Fairly and Accurately Represent Shareholders in Derivative Actions).

Plaintiff Must Have Standing to Sue

Federal and state courts require a plaintiff to be a shareholder when filing a derivative lawsuit and remain a shareholder throughout the litigation to maintain a shareholder derivative lawsuit. Several key issues must be considered regarding the standing requirement in shareholder derivative litigation, including:

- How to determine the shareholder's identity (see How to Determine the Shareholder's Identity).
- The requirement that a plaintiff be a shareholder (see Plaintiff Must Be a Shareholder throughout the Litigation).
- The effect of a merger on a shareholder's standing (see Effect of Merger on Plaintiff's Standing).
- The ability to bring a double derivative action (see Double Derivative Lawsuits).

How to Determine the Shareholder's Identity

Depending on the jurisdiction, only certain types of shareholders may bring a derivative lawsuit. Some courts have held that a plaintiff only needs to be a record owner of stock to have standing to bring a shareholder derivative lawsuit (see *Quality Dev., Inc. v. Thorman*, 31 P.3d 296, 301-02 (Kan. Ct. App. 2001)). A record owner of stock is an individual that holds legal title to the shares (*Quality Dev., Inc.*, 31 P.3d at 301). Other courts have held a plaintiff may be either a record or beneficial owner of stock to bring a derivative lawsuit (see, for example, *Parfi Holding AB v. Mirror Image Internet, Inc.*, 954 A.2d 911, 939 (Del. Ch. 2008)). A beneficial owner of stock is an individual that may not have legal title to the shares, but receives some type of economic benefit from them (*Parfi Holding AB*, 954 A.2d at 939, n.105).

Shareholders do not have to own common stock to have standing to bring a derivative claim. Owners of preferred stock have standing to bring a derivative claim absent an express restriction in the certificate of designation of the preferred stock (*MCG Capital Corp.*, 2010 WL 1782271, at *6).

Plaintiff Must Be a Shareholder Throughout the Litigation

To have standing to bring a shareholder derivative lawsuit, most states require the plaintiff to be a shareholder of the corporation:

- At the time the derivative lawsuit is filed.
- When the challenged transaction occurred.
- Throughout the entire litigation.

Generally, only an owner of stock at the time the derivative lawsuit is filed and when the challenged transaction occurred may bring a shareholder derivative lawsuit (see *7547 Partners v. Beck*, 682 A.2d 160, 163 (Del. 1996)). A plaintiff may still bring a derivative lawsuit even when its ownership interest in the corporation's stock has devolved or extinguished due to an intervening legal event, such as a merger of the company into another (for example, DGCL § 327).

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Under Delaware law, the plaintiff must usually also continue to be a shareholder throughout the litigation. This requirement is known as the contemporaneous ownership requirement. The purpose of the contemporaneous ownership requirement is to:

- Eliminate the commencement of the shareholder derivative lawsuit by non-shareholders.
- Prevent a windfall to a plaintiff who has already accepted the benefits of selling its shares of stock in the corporation.

(*In re Gaylord Container Corp. S'holders Litig.*, 747 A.2d. at 82.)

The contemporaneous ownership requirement has come under criticism by many academics, as well as by the Delaware Court of Chancery itself, in the view that the corporation stands to benefit unfairly if a risk-averse shareholder sells his claim to a new shareholder who is willing to pursue a derivative claim (see *In re Activision Blizzard Inc. S'holder Litig.*, 124 A.3d 1025, 1047-48 (Del. Ch. 2015)). Consequently, some courts hold that continuous ownership is unnecessary where a shareholder plaintiff acquired stock after the challenged transaction occurred if the alleged wrong continued after the acquisition (see, for example, *Ensign Corp., S.A. v. Interlogic Trace, Inc.*, 1990 WL 213085, at *2 (S.D.N.Y. Dec. 19, 1990)). This exception is known as the continuing wrong doctrine. Several states have codified this exception in their statutes (for example, Cal. Corp. Code § 800).

Effect of Merger on Plaintiff's Standing

The merger of a targeted corporation into another corporation, specifically a merger where the acquiring company exchanges cash for shares in the acquired company, usually deprives a shareholder of the targeted corporation of standing to bring a derivative lawsuit. The prospective derivative plaintiff loses its shareholder status as a result of the merger because the shareholder no longer has an ownership interest in the newly formed corporation (*Lewis v. Anderson*, 477 A.2d 1040, 1047 (Del. 1984)).

However, under Delaware law, a merger does not necessarily deprive the plaintiff of its standing to sue derivatively if the merger:

- Is the subject of a claim of fraud that the merger was effected solely to deprive shareholders of standing to sue (see *Lewis v. Ward*, 852 A.2d. 896, 902 (Del. 2004); but see *Siegmund v. Xuelian Bian*, 2016 WL 1444582, at *6 (S.D. Fla Apr. 11, 2016) (declining to apply the fraud exception described in *Lewis v. Ward* to Florida law)). An allegation that the merger at issue was necessitated by and inseparable from the alleged fraud, but was not itself fraudulent, does not survive the merger as a derivative claim and can only be brought directly (*Ark. Teacher Ret. Sys. v. Countrywide Fin. Corp.*, 75 A.3d 888, 897 (Del. 2013)).
- Has not changed the shareholder's ownership interest because the merger was merely a reorganization of the corporation (see *Lewis*, 477 A.2d at 1046, n.10).
- Results in the creation of a wholly owned subsidiary on whose behalf the shareholder plaintiff has brought suit (see *Blasband v. Rales*, 971 F.2d 1034, 1041 (3d Cir. 1992); but see *In re: Merrill Lynch & Co., Inc. Sec. Deriv. and ERISA Litig.*, 597 F. Supp. 2d 427, 430 (S.D.N.Y. 2009)).
- Provides shareholders of the acquired corporation shares of stock in a newly formed corporation which has the basic corporate identity and structure of the acquired corporation (*Blasband*, 971 F.2d. at 1041).

Double Derivative Lawsuits

Normally the plaintiff in a shareholder derivative lawsuit must own stock in the company on whose behalf the suit is brought. However, in some situations the plaintiff may sue derivatively on behalf of a different company that is affiliated with another company in which it does own stock. These lawsuits are known as double derivative suits (*Lambrecht v. O'Neal*, 3 A.3d 277, 282 (Del. Ch. 2010)). There are two categories of double derivative lawsuits, which are lawsuits originally brought:

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- By a shareholder of a parent corporation for injuries to a pre-existing, wholly-owned subsidiary corporation.
- On behalf of a corporation that is acquired by another corporation in a stock-for-stock merger (meaning the plaintiff now owns stock in the new corporation).

(*Lambrecht*, 3 A.3d at 282.)

Double derivative suits present a few unique procedural characteristics not found in standard derivative suits. For example:

- If a stockholder of the parent corporation brings a double derivative suit on behalf of a subsidiary, both the parent and subsidiaries become indispensable parties to the suit (*Sternberg*, 550 A.2d at 1124).
- For a shareholder to bring and maintain a double derivative action, it must have either:
  - made a demand to the boards of both the acquired and acquiring companies; or
  - alleged demand would be futile for both companies unless the merger results in one company becoming a wholly-owned subsidiary of the other, which then requires the shareholder to make a demand only at the parent level.

(*Rales v. Blasband*, 634 A.2d 927, 934 (Del. 1993) and *Lambrecht*, 3 A.3d at 288-289.)

Plaintiffs Must Fairly and Accurately Represent Shareholders in Derivative Actions

The representative plaintiff in a shareholder derivative suit must adequately represent the interests of the other shareholders when bringing the action. To establish adequacy, the representative must demonstrate that it can vigorously and conscientiously prosecute the derivative lawsuit and is free from economic interests that are hostile to those of the other shareholders (see, for example, *Canadian Commercial Workers Indus. Pension Plan v. Alden,* 2006 WL 456786, at *8 (Del. Ch. Feb. 22, 2006)).

Fair and adequate representation is especially important in shareholder derivative lawsuits because shareholders have no right to opt out of the derivative action (see *Powers v. Eichen*, 229 F.3d 1249, 1255 (9th Cir. 2000)).

In shareholder derivative lawsuits, it must be determined whether the requirement for fair and adequate representation has been met by analyzing the:

- Burden of proof to demonstrate fair and adequate representation (see Burden of Proof to Demonstrate Fair and Adequate Representation).
- Factors the court considers to determine fair and adequate representation (see Factors the Court Considers to Determine Fair and Adequate Representation).

Burden of Proof to Demonstrate Fair and Adequate Representation

In shareholder derivative suits, the burden of proof is on the defendant to show that the lead plaintiff does not adequately represent the interests of the other shareholders (*Powers*, 229 F.3d at 1254-1255). This burden-shifting lies in stark contrast to class actions brought under Rule 23 of the Federal Rules of Civil Procedure (FRCP) (or analogous state rules), where the plaintiff has the burden to prove it intends to fairly represent the class members.

Factors the Court Considers to Determine Fair and Adequate Representation

When presented with a challenge to the adequacy of representation, courts generally weigh the same

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considerations applicable to proposed representatives in a class action (see *Canadian Commercial Workers Indus. Pension Plan*, 2006 WL 456786, at *8). The factors courts consider to assess the adequacy of a proposed representative in a shareholder derivative lawsuit include:

- The status of the plaintiff as a party having an identifiable interest in the outcome of the lawsuit.
- The plaintiff's unfamiliarity with the litigation and unwillingness to learn about the lawsuit.
- The degree of control the attorneys exercise over the litigation.
- The degree of support the plaintiff receives from other shareholders.
- The representative plaintiff's lack of any personal commitment to the action.
- The remedy the plaintiff seeks in the derivative action.
- The magnitude of the plaintiff's own interests as compared to its interest in the derivative action itself, such as using the derivative lawsuit to gain a more advantageous settlement in another lawsuit.
- The maintenance of a shareholder derivative lawsuit and a putative class action by the same plaintiffs and attorneys.
- The plaintiff's vindictiveness toward the defendants.

(*Larson **v**. Dumke*, 900 F.2d 1363, 1367 (9th Cir. 1990).)

Whether the Plaintiffs May Assert Direct and Derivative Claims

A related concern when choosing the plaintiff arises when the plaintiff alleges both direct and derivative claims. This raises the possibility of an inherent conflict of interest for the plaintiffs' counsel, because at the same time that the plaintiffs assert the direct claims as stockholders against the company and its board, they simultaneously assert derivative claims on behalf of the company against the board. This possible conflict may, in some situations, be strong enough to warrant bifurcating the litigation or dismissing either the direct or derivative claims. However, the court will have less of a concern if the direct and derivative claims are not inconsistent with each other. (See *In re Ebix, Inc. S'holder Litig.*, 2014 WL 3696655, at *18.)

Pre-Suit Demand on the Board

Before filing a shareholder derivative suit, a plaintiff must usually make a demand to the board of directors to take a specified action or pursue legal claims to bring a shareholder derivative lawsuit. Requiring the shareholder to make a demand provides the corporation with the opportunity to take control of the proposed litigation (*Spiegel **v**. Buntrock*, 571 A.2d 767, 773 (Del. 1990)). In shareholder derivative lawsuits, it must be determined if the demand requirement has been met by addressing:

- What the demand requirement is (see Overview of the Demand Requirement).
- How the demand is made (see How the Demand is Made).
- The response to a demand (see Responding to the Demand).
- Situations when demand on the board is excused (see When Demand Requirement is Excused).

Overview of the Demand Requirement

A plaintiff seeking to bring and maintain a shareholder derivative lawsuit must first attempt to request corporate action by making a demand to the board (***Grimes v. Donald***, 673 A.2d at 1207). The purpose of the demand requirement is to:

- Ensure that the fundamental principle that the board, and not individual shareholders, manages

the affairs of a corporation (see *In re AIG, Inc.*, 965 A.2d 763, 808 (Del. Ch. 2009)).

- Allow corporate management to explore remedies other than litigation to resolve the shareholder's claims (*Cramer v. Gen. Tel. & Elecs. Corp.*, 582 F.2d 259, 275 (3d Cir. 1978)).
- Discourage plaintiffs from bringing meritless claims and prevent the corporation from incurring unnecessary legal expenses (*Cramer*, 582 F.2d at 275).

How the Demand Is Made

To make a proper demand for corporate action, the shareholder must usually make the demand on the board of directors before initiating a derivative lawsuit. Some states permit a shareholder to make a demand on someone other than the board if that party is of comparable authority (see *Scalisi v. Fund Asset Mgmt., L.P.*, 380 F.3d 133, 138 (2d Cir. 2004)).

Generally the stockholder must make a written demand (for example, Texas Business Corporation Act § 5.14). This written demand may take various forms, but is typically drafted as a letter to the board (*Khanna v. McMinn*, 2006 WL 1388744, at *13 (Del. Ch. May 9, 2006)).

To demand action from a board, the shareholder should deliver to the board, or other appropriate authority, a letter containing enough facts to allow the board to properly respond to the demand (*Stoner v. Walsh*, 772 F. Supp. 790, 797 (S.D.N.Y. 1991)). Individual state statutes and case law specify exactly what information the shareholder must include in a demand to the corporation. Generally, the demand letter should contain the:

- Identity of the wrongdoer.
- Harm to the corporation.
- Requested relief.
- Date the shareholder purchased stock.
- Length of time the shareholder has held stock in the corporation.

(*Yaw v. Talley*, 1994 WL 89019, at *7 (Del. Ch. Mar. 7, 1994); *Richelson v. Yost*, 2010 WL 3563108, at *7 (E.D. Pa. Sept. 9, 2010).)

Responding to the Demand

When a shareholder makes a demand on the board, the shareholder effectively hands over control of the derivative litigation to the board of directors (*Spiegel*, 571 A.2d at 773). The board can then decide whether to:

- Pursue the claims identified in the demand.
- Resolve the grievance.
- Reject the demand.

(*Weiss v. Temp. Inv. Fund, Inc.*, 692 F.2d 928, 941 (3d Cir. 1982).)

The issues raised by a board's response to a shareholder's demand, include:

- The process used by a board to evaluate a shareholder's demand (see Process Used by Board of Directors to Evaluate Shareholder's Demand).
- When the board must respond to a shareholder's demand (see When the Board Must Respond to Shareholder's Demand).
- The effect of the board's response to a shareholder's demand (see Effect of Board's Response on Shareholders Claims).

Process Used by Board of Directors to Evaluate Shareholder's Demand

After receiving a shareholder's demand, the board may either:

- Act on its own to review a shareholder's demand.
- Appoint a special litigation committee (SLC), also known at this stage as a special review committee, to investigate the facts at the

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heart of the demand and make a report and recommendation regarding the demand.

(See, for example, *Seminaris v. Landa*, 662 A.2d 1350 (Del. Ch. 1995).)

Both the board and the SLC may rely on the advice of experts and outside counsel when evaluating the shareholder's demand. Once either the board or SLC decides how to proceed with the shareholder's demand, it notifies the shareholder, usually in the form of a letter (see, for example, *Graulich v. Dell Inc.*, 2011 WL 1843813, at *3 (Del. Ch. May 16, 2011)).

For more information on Special Litigation Committees, see Practice Note, Shareholder Derivative Litigation: Special Litigation Committees.

When the Board Must Respond to Shareholder's Demand

After making a demand on the board of directors, the plaintiff may not take any action regarding the claim until the board has acted on it (see *Zapata Corp.*, 430 A.2d at 784). The board must promptly inform the shareholder who made the demand what action the board decides to take in response. Courts generally give the board a reasonable amount of time to respond to the shareholder's demand (*Allison v. General Motors Corp.*, 604 F. Supp. 1106, 1117-18 (D. Del. 1985)).

Determining whether the board's response time was reasonable depends on the facts of the case. Courts have held that a shareholder filed a derivative suit prematurely when the shareholder:

- Filed a complaint four and a half months after making a demand on the board of directors to take the requested action (*In re Smith & Wesson Holding Corp. Deriv. Litig.*, 2010 WL 4119242, at *2 (D. Mass. Oct. 20, 2010)). The US District Court for the District of Massachusetts found that the time between the initial demand and the filing of the complaint was an insufficient period of time for the board to fully investigate the plaintiffs' claims after the plaintiffs failed to provide additional information twice requested by the special litigation committee (*In re Smith & Wesson Holding Corp. Deriv. Litig.*, 2010 WL 4119242, at *4).
- Was a shareholder of an insolvent bank and filed the complaint two months after making a demand on the FDIC, the appointed receiver for the bank (*Renfro v. F.D.I.C.*, 773 F.2d 657, 659 (5th Cir. 1985)). The court found that the plaintiff did not provide enough information for the FDIC to properly investigate the demands (*Renfro*, 773 F.2d at 660).
- Filed the complaint approximately two months after making a demand because the amount of time was not sufficient for the board to investigate the extent of the damage incurred by the corporation from the defects in the corporation's products described in the plaintiff's demand (*Allison*, 604 F.Supp. at 1118).
- Filed a complaint only two weeks after making a demand on the board without providing enough information for the board to make a reasonable investigation into the demand (*Smachlo v. Birkelo*, 576 F.Supp. 1439, 1445 (D. Del. 1983)).

Derivative plaintiffs frequently argue that a board's failure to provide them with a definitive response to a demand letter within a reasonable time indicates the futility of the demand.

While a shareholder may bring a derivative lawsuit under these circumstances, the lawsuit is still susceptible to dismissal based on a failure to make a demand on the board because there is no precise rule on how much time a board has to respond to a shareholder's demand (see *Allison*, 604 F.Supp. at 1117-1118).

Effect of Board's Response on Shareholder's Claims

The board may either accept or reject a shareholder's demand for the corporation to pursue litigation. If the board accepts the shareholder's demand and pursues the requested litigation, then the board assumes control of the litigation by placing the corporation's resources, including its information, personnel, funds, and counsel, behind the lawsuit (*Daily Income Fund, Inc.*, 464 U.S. at 533).

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Once a shareholder makes a demand on the board, it tacitly concedes the independence of a majority of the board to respond. Consequently, if the board rejects the shareholder's demand, the rejection is treated the same as any other action taken by an independent and disinterested board and is entitled to the presumption of the business judgment rule (*Spiegel*, 571 A.2d at 775-76). Accordingly, the plaintiff can only bring the derivative lawsuit in spite of the board's rejection if the shareholder can allege particularized facts that raise a reasonable doubt as to whether the board's rejection was made in good faith or was not grossly negligent (*Spiegel*, 571 A.2d at 777; *Espinoza ex rel. JPMorgan Chase & Co. v. Dimon*, 124 A.3d 33, 36 (Del. 2015)). (Although a showing of bad faith is necessary for purposes of director liability if the corporation has an exculpatory provision in its certificate of incorporation, a showing of gross negligence is enough for the narrower purpose of demonstrating that the board's rejection of the demand was wrongful (*Rich ex rel. Fuqi Intern., Inc. v. Yu Kwai Chong*, 66 A.3d 963, n.117 (Del. Ch. 2013)).) If the court finds that the board met the requirements of the business judgment rule when rejecting a shareholder's demand, the court respects the board's decision to not pursue the requested litigation (*Spiegel*, 571 A.2d at 777).

When Demand Requirement Is Excused

The demand requirement is excused if the shareholder plaintiffs show that making a demand on the board would be futile (see *Khanna*, 2006 WL 1388744, at *14). Because it is difficult to demonstrate that a board's refusal of a demand was improper, many shareholder derivative plaintiffs instead make the demand-futility argument, before making a demand on the board. If the shareholder has already made a demand on the board, it can no longer allege demand futility (*Spiegel*, 571 A.2d at 775).

Shareholder derivative plaintiffs must plead facts with particularity that demonstrate the futility of making a demand on the board (*Aronson*, 473 A.2d at 815). The courts look only to the allegations in the complaint to determine whether a demand on the board would be futile (*Khanna*, 2006 WL 1388744, at *14). Discovery is not permitted to demonstrate demand futility (see *In re Merck & Co., Inc. Sec., Derivative & ERISA Litig.*, 493 F.3d 393, 398 (3d Cir. 2007); *Mizel v. Connelly*, 1999 WL 550369, at *5 (Del. Ch. Aug. 2, 1999)). Plaintiffs are expected to first inspect the company's books and records to learn the facts necessary to demonstrate demand futility (***Grimes v. Donald***, 673 A.2d at 1216 n.11; see Pre-Suit Access to Corporate Records).

Once an initial complaint pleads particularized facts to demonstrate demand futility, the plaintiff does not need to re-demonstrate futility for an amended complaint, even if the board composition has subsequently changed (*Harris v. Carter*, 582 A.2d 222, 231 (Del. Ch. 1990)). However, if the amended complaint seeks to assert a new and distinct cause of action derivatively, the plaintiff must first establish the futility of making a demand on the new board to bring that new claim (*Fotta v. Morgan*, 2016 WL 775032, at *14 (Del. Ch. Feb. 29, 2016)).

To show demand futility in a derivative lawsuit concerning an action the board took on behalf of the corporation, shareholder plaintiffs must plead facts that reasonably call any of the following into question:

- The directors' disinterest in the underlying action (see Director's Interest in the Underlying Action).
- The directors' independence in the underlying action (see Director's Independence in the Underlying Action).
- Whether the board's action was the product of a valid exercise of business judgment (see Aronson: Valid Exercise of Business Judgment).

(*Aronson*, 473 A.2d at 814; *Brehm*, 746 A.2d at 256.)

The Delaware courts frequently refer to this pleading requirement as the two-prong *Aronson* test, in which the first prong is a finding of reasonable doubt as to either the directors' disinterest or independence (which negates the protections of the business judgment rule) and the second prong refers to a finding that the board's action was not a valid exercise of business judgment. The court's inquiry into the directors' disinterest and independence is conducted on a director-by-director basis, but to satisfy that prong, the plaintiffs must demonstrate that at least half the directors were

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interested or not independent (*In re infoUSA, Inc. S'holders Litig.*, 953 A.2d 963, 989-90 (Del. Ch. 2007)). Moreover, even if a majority of the entire board was not independent, the defendants can establish independence if the action in question was taken by a committee of the board comprised of a majority of independent directors (*In re Tyson Foods, Inc. Consol. S'holder Litig.*, 919 A.2d 563, 589 (Del. Ch. 2007); *Teamsters Union 25 Health Serv. & Ins. Plan v. Baiera*, 119 A.3d 44, n.119 (Del. Ch. 2015)).

By contrast with claims over an action, when plaintiffs bring a derivative suit based on board **inaction**, they must plead facts indicating that, at the time they filed the complaint, there is a reasonable doubt that the board could have exercised its business judgment when responding to the shareholder's demand (*Rales*, 634 A.2d at 934). This is commonly referred to as the *Rales* test. The *Rales* test differs from the second prong of the *Aronson* test in that its analysis focuses on the board as it was composed at the time of the suit's filing, not as it was composed when the underlying action was taken. Consequently, the *Rales* test applies when a majority of the directors who took the allegedly wrongful action have since been replaced, or even if a majority of the **interested** directors have been replaced while a majority of the overall board remains the same (*Sandys v. Pincus*, 152 A.3d 124, 127-28 (Del. 2016)). The *Rales* test also applies if the plaintiff bases its claim on allegations that the directors took wrongful action in their capacity as individuals (such as by selling shares of the company while in possession of insider information), not on an allegation regarding an action taken by the entire board (*In re Career Educ. Corp. Deriv. Litig.*, 2007 WL 2875203, at *12 (Del. Ch. Sept. 28, 2007).

The Delaware Court of Chancery has considered the argument that in any situation involving allegations of self-dealing by a controlling stockholder, which invoke the "entire fairness" standard of review, demand should automatically be considered futile under either of the tests. The court rejected this theory and held that the demand-futility inquiry must still be applied to each director (*Teamsters Union 25 Health Serv. & Ins. Plan v. Baiera*, 119 A.3d at 65-67).

Director's Interest in the Underlying Action

To find that the board had a disabling interest that would render demand futile, federal courts require evidence that the board was "actively involved" in the action complained of in the lawsuit, beyond "mere acquiescence" to it (*Gaubert v. Fed. Home Loan Bank Board*, 863 F.2d 59, 65 (D.C. Cir. 1988)). For this purpose, it is not enough to allege that the directors are interested in the outcome of the litigation and will therefore refuse to file suit against themselves. Rather, the question of interest turns on the directors' interest in the underlying action. Consequently, the issue usually arises when a director has a personal financial interest in the outcome of the action.

Under Delaware law, the test for interest on the part of a director is met if either:

- The director has a material financial interest in a transaction with a third party that is not shared equally by the shareholders and that prevents the director from exercising the duties of directors without being unduly influenced (*Cal. Pub. Employees Ret. Syst. v. Coulter*, 2002 WL 31888343 (Del. Ch. May 28, 2002)).
- The transaction involves any self-dealing on the part of the director, in which case no materiality standard applies (*Cambridge Ret. Sys. v. Bosnjak*, 2014 WL 2930869, at *4 (Del. Ch. June 26, 2014)).

In *Bosnjak*, the court explained that directors' own compensation for their service as directors qualifies as self-dealing and that demand on them for claims of excessive compensation is excused (2014 WL 2930896, at *3 (citing *Steiner v. Meyerson*, 1995 WL 441999, at *11 (Del. Ch. 1995)). On the other hand, in a case where the directors of a corporation sold stock after using faulty accounting to inflate the corporation's stock price, the plaintiff was required to meet the materiality standard because the sale was not made to the corporation itself and therefore was not considered self-dealing (*Guttman v. Huang*, 823 A.2d 492, 502 (Del. Ch. 2003)).

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When directors undertake defensive measures in contests for corporate control, the directors' disinterest can be called into question without any allegations of self-dealing. In these situations, the particularized factual allegations must demonstrate that the directors' sole or primary motivation was entrenchment (*Grobow v. Perot*, 539 A.2d 180, 188 (Del. 1988) overruled on other grounds by *Brehm*, 746 A.2d 244, 253-54 (Del. 2000)). However, before entrenchment can be established as a motivation, the directors must be shown to have perceived an actual threat of their removal. Scenarios in which an activist shareholder seeks to add a director and might eventually consider launching a proxy contest will not be considered sufficient to rebut the presumptions of the business judgment rule and invoke enhanced scrutiny under *Unocal* (*Ryan v. Gursahaney*, 2015 WL 1915911, at *7 (Del. Ch. Apr. 28, 2015)).

Plaintiffs are also entitled to an inference of interest on the part of the directors when the complaint indicates a "substantial likelihood" that the directors will be found liable for their actions (see *Rales*, 634 A.2d at 936). In that situation, the directors' own self-interest would prevent them from considering a demand objectively. For example, the "substantial likelihood of liability" standard was met in a case where it was alleged that the board of directors knowingly made misrepresentations to its shareholders (*In re InfoUSA*, 953 A.2d at 994).

Director's Independence in the Underlying Action

A director is considered independent if the director can make business decisions without being influenced by or considering extraneous factors (*Blasband*, 971 F.2d at 1048). A board comprised of outside directors who are not otherwise alleged to be beholden to or controlled by an interested director is presumptively independent (see *Zimmerman v. Bell*, 800 F.2d 386, 392 (4th Cir. 1986)). A director is presumed to be independent even when appointed by a controlling shareholder or other allegedly interested party (*Aronson*, 473 A.2d at 816).

To successfully challenge a director's independence, shareholder plaintiffs must show that the director is so "beholden" to the controlling shareholder or "so under that shareholder's influence that the director's discretion would be sterilized" (*Rales*, 634 A.2d at 936). Bare allegations that a director is friendly with or has had past business relationships with the controlling shareholder who is a proponent of the transaction are not enough to rebut the presumption of independence. The mere fact of compensation from the corporation is not enough (*In re The Limited, Inc.*, 2002 WL 537692, at *5 (Del. Ch. Mar. 27, 2002); *Seidl v. Am. Century Cos., Inc.*, 799 F.3d 983, 991 (8th Cir. 2015)). Rather, the director's ties to the controller must be sufficiently substantial, from a subjective point of view, that the director could not have objectively evaluated the transaction (see *Kahn v. M & F Worldwide Corp.*, 88 A.3d 635, 648-49 (Del. 2014)).

Determining whether a director is independent is a fact-specific inquiry. For example, courts have held that:

- A director was independent and not forced to approve a challenged transaction by the chief executive officer (CEO) of the corporation even though the director maintained a 15-year long professional and personal relationship with the CEO (*Crescent/Mach I Partners, L.P. v. Turner*, 846 A.2d 963, 981 (Del. Ch. 2000)).
- Where a director had served on the boards of two other companies owned by a venture capital firm with a financial interest in the challenged transaction and served as a high ranking executive in other companies owned by that firm, there was reasonable doubt regarding the director's independence (*Goldman v. Pogo.com, Inc.*, 2002 WL 1358760, at *3 (Del. Ch. Jun. 14, 2002)).
- Where a plaintiff alleged that directors mismanaged two facilities owned and operated by the corporation, the New Jersey Supreme Court found the directors to be independent because merely approving a challenged transaction is insufficient to show that a director was interested in the transaction (*In re PSE&G S'holder Litig.*, 173 N.J. 258, 289 (N.J. 2002)).
- Where plaintiffs alleged that the board did not have the requisite independence because of a familial relationship, a majority of the board must share the familial interest for the challenge to

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succeed (see *Ji v. Van Heyningen*, 2006 WL 2521440, at *7 (D. R.I. Aug. 29, 2006)).

- The members of a compensation committee were independent even though they had been appointed by the controlling stockholder, had served on the board for many years, served on the boards of other entities controlled by the stockholder, were over 70 years old, and were otherwise retired (*Friedman v. Dolan*, 2015 WL 4040806 (Del. Ch. Jun. 30, 2015)).

At the same time, the Delaware Supreme Court has cautioned that a director's personal and business ties to an interested party cannot be analyzed separately from each other, but must be considered in their totality (*Del. Cnty. Emps. Ret. Fund v. Sanchez*, 124 A.3d 1017 (Del. 2015)). The *Sanchez* court also held that a long-term friendship carries a greater inference of compromise of independence than do "thin, social-circle friendships." As a result, the court found that a plaintiff satisfied its burden under *Aronson* regarding a director who derived his primary employment and income from the company and who had a close friendship of over 50 years with the company's chairman and largest stockholder.

A director's qualification or disqualification for independence under relevant stock exchange rules is frequently cited by Delaware courts as a useful guide for determining whether that director should qualify as independent under Delaware law (see *EZCORP*, 2016 WL 301245, at *36). However, the court may consider a director independent for demand-futility purposes even if that director would not qualify as independent under the relevant stock exchange rule (see *Teamsters Union 25 Health Serv. & Ins. Plan v. Baiera*, 119 A.3d at 61).

Aronson: Valid Exercise of Business Judgment

If the plaintiff fails to establish that a majority of the directors were interested in the transaction or otherwise not independent, there is a presumption the directors properly exercised their business judgment (see *Aronson*, 473 A.2d at 812). Overcoming this presumption is a "heavy burden" for a plaintiff (*White v. Panic*, 783 A.2d 543, 551 (Del. 2001)). The challenge is made harder if the corporation's certificate of incorporation contains an exculpatory provision permitted by Section 102(b)(7) of the DGCL. If it does, the court cannot find the directors liable for a breach of their fiduciary duty of care. Consequently, the plaintiff must show that the challenged actions either:

- Constituted waste (*Seinfeld v. Slager*, 2012 WL 2501105, at *3 (Del. Ch. June 29, 2012)). Waste is established when an exchange is "so one-sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration." This is a stringent standard that is only met in the "rare, unconscionable case where directors irrationally squander or give away corporate assets." (*In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 74 (Del. 2006), citing *Brehm*, 746 A.2d at 263.)
- Were taken in bad faith in violation of the directors' duty of loyalty. Bad faith is established if a director either:
  - intentionally acts with a purpose other than that of advancing the best interests of the corporation;
  - acts with the intent to violate applicable positive law; or
  - fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.

  (*Disney*, 906 A.2d at 67.)

Under Delaware law, directors who rely in good faith on expert opinions when evaluating business decisions are entitled to legal protection (DGCL § 141(e)). In this situation, courts presume the board properly exercised its business judgment unless the shareholder plaintiff shows that:

- The directors did not actually rely on the expert.
- The directors' reliance was in bad faith.
- The directors did not reasonably believe that the expert's advice was within the expert's professional competence.

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- The expert was not selected with reasonable care by or on behalf of the corporation by the board.
- The board failed to consider information that was obviously material and readily available and the failure to consider such information amounted to the board's gross negligence.
- The decision of the board was so unconscionable that it constituted waste or fraud.

(*Brehm*, 746 A.2d at 262.)

Rales: Inability to Respond to the Demand

When a plaintiff pursues a derivative claim against a board for a failure to act, the plaintiff must meet the test set forth in *Rales v. Blasband*. Under *Rales*, the plaintiff must plead, with particularity, factual allegations creating a reasonable doubt that the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand.

The plaintiff can meet this standard if it raises reasonable doubt as to a majority of the directors' independence or financial disinterest, under the same standards described in the context of the *Aronson* test. The plaintiff also meets the standard if it demonstrates that the board faced a substantial likelihood of personal liability for the conduct alleged in the complaint, sufficient to compromise their ability to consider a demand impartially. The "substantial likelihood of personal liability" standard for pleading interestedness is rigorous, and the likelihood of liability must be substantial, not a "mere threat" (*In re Goldman Sachs Gp., Inc. S'holder Litig.*, 2011 WL 4826104, at *18 (Del. Ch. Oct. 12, 2011)).

In *Rales* actions, plaintiffs often allege personal liability by making a "*Caremark* claim" that the board in bad faith failed to oversee the company (see *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996)). Director liability under *Caremark* arises where either:

- The directors utterly failed to implement any reporting or information system or controls.
- Having implemented such a system or controls, the directors consciously failed to monitor or oversee its operations, thus disabling themselves from being informed of risks or problems requiring their attention. This basis for liability has been held to require pleading with particularity that there were "red flags" that put the directors on notice of problems with their systems, but which were consciously disregarded (*Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 373 (Del. 2006)).

Caremark claims are generally recognized as "possibly the most difficult theory in corporation law on which a plaintiff might hope to win a judgment" (*General Motors*, 2015 WL 3958724, at *14). If, however, the plaintiff's complaint pleads specific acts of fraud at a corporation, the plaintiff does not need not tie the fraud to each particular defendant director. The court can draw inferences that the directors were aware of the fraud and knowingly failed to stop it (*In re Am. Int'l Group, Inc.*, 965 A.2d 763, 799 (Del. Ch. 2009); *In re China Agritech S'holder Deriv. Litig.*, 2013 WL 2181514, at *24 (Del. Ch. May 21, 2013)).

Litigating a Shareholder Derivative Lawsuit

Shareholder derivative suits can give rise to several important litigation issues including:

- Subject matter jurisdiction (see Subject Matter Jurisdiction).
- Personal jurisdiction (see Personal Jurisdiction).
- Venue (see Venue).
- Choice of law (see Choice of Law).
- Drafting the shareholder complaint (see Drafting the Shareholder Complaint).
- Responding to the complaint (see Responding to the Complaint).

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- Discovery and privilege (see Discovery in Shareholder Derivative Lawsuits).

Subject Matter Jurisdiction

Shareholder derivative suits are typically based on state-law claims of breach of fiduciary duty. Therefore, plaintiffs often file derivative lawsuits in state court. Many states permit their courts of general jurisdiction to hear any type of suit, including shareholder derivative suits (N.Y. Const. art. VI, § 7(a); see, for example, *In re Topps Co., Inc. S'holder Litig.*, 2007 WL 5018882, at *5 (Sup. Ct. N.Y. Cty. Jun. 8, 2007)). Other states vest exclusive jurisdiction over shareholder derivative suits in specialized courts. In Delaware, for example, the Delaware Court of Chancery has exclusive jurisdiction to hear shareholder derivative suits (10 Del. C. § 341).

Instead of filing suit in state court, a shareholder may elect to bring a derivative suit in federal district court if federal **subject matter jurisdiction** exists over the case. Federal subject matter jurisdiction over shareholder derivative suits is usually limited to cases that fall within the federal courts' **diversity jurisdiction** (see, for example, *Kalin v. Xanboo, Inc.*, 2009 WL 928279, at *4 (S.D.N.Y. Mar. 30, 2009)). Generally a federal district court may exercise diversity jurisdiction over a case where:

- The plaintiff(s) and defendant(s) are citizens of different states.
- The amount in controversy exceeds $75,000 exclusive of interest and costs.

(28 U.S.C. § 1332(a).)

When determining the citizenship of the parties for diversity purposes, the court is not bound by how the parties are aligned in the complaint (*Symes v. Harris*, 472 F.3d 754, 761 (10th Cir. 2006)). Even though corporations are listed as nominal defendants, courts generally realign them as a plaintiff because they are the real party in interest in a derivative suit (*Obstfeld v. Schwartz*, 621 F.Supp.2d 87, 93 (S.D.N.Y. 2008)). If the corporation is antagonistic to the plaintiff's interest, such as when it is under the control of management with antagonistic interests to the plaintiff, the court considers the corporation to be a defendant to the derivative suit (*Khoury v. Oppenheimer*, 540 F. Supp. 737, 738 (D. Del. 1982)). Once a court properly aligns the named parties' interests in the derivative suit, it may then evaluate whether the required diversity of citizenship among the properly aligned parties exists (*Symes*, 472 F.3d at 761).

Even if a federal district court does not have diversity jurisdiction over the shareholder derivative suit, it may still exercise **supplemental jurisdiction** over the case if the derivative suit arises from the same nucleus of facts as another claim properly before the court (28 U.S.C. § 1367(a); see, for example, *In re Bank of Am. Corp. Sec., Deriv., and ERISA Litig.*, 757 F. Supp. 2d 260, 334 (S.D.N.Y. 2010)).

A defendant may also remove a shareholder derivative suit to federal district court (*Cucci v. Edwards*, 510 F. Supp. 2d 479, 485 (C.D. Cal. 2007)). To properly remove a case to federal court, the defendant must show that federal subject matter jurisdiction exists over the case and that the procedural requirements for removal have been met (*Cucci*, 510 F. Supp. 2d at 482).

It should be noted that a defendant may not remove a case to federal district court on the basis of diversity jurisdiction when one of the properly joined defendants is a citizen of the state in which the shareholder plaintiff brings the action (28 U.S.C. § 1441(b)). Where a court finds that a corporation's interests are antagonistic to the interests of the shareholder plaintiff, that corporation is aligned as a defendant to the derivative suit by the court (*Khoury*, 540 F. Supp. at 738).

Therefore, in a state like Delaware, where a majority of corporations are incorporated, when a corporation is aligned as a defendant to a derivative suit, defendants may not remove the suit from the Delaware Court of Chancery to the federal district court because the corporation is a citizen of the state where the shareholder plaintiff brought the action (*Khoury*, 540 F. Supp. at 738).

Personal Jurisdiction

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As in other civil litigation, courts must have personal jurisdiction over the defendant(s) in a shareholder derivative suit (see, for example, *Carroll v. O'Brien*, 1993 WL 118481, at *1 (SDNY Apr. 12, 1993)). To invoke personal jurisdiction over a defendant in a derivative suit, a shareholder plaintiff must make a prima facie showing that the defendant engaged in a continuous course of "doing business" in the state (the requisite minimum contacts) or that the defendant committed the wrong in the state (*Carroll*, 1993 WL 118481, at *1; N.Y. C.P.L.R. §§ 301-302).

For example, where a nonresident defendant conducted business in New York State through various means of communication, the New York Supreme Court held that it had personal jurisdiction over the defendant to the shareholder derivative suit (*Camel Invs. Ltd. v. Transocean Capital*, 195 A.D.2d 533, 534 (N.Y. App. Div. 2d Dept. 1993)).

Certain states also have statutes specifically providing for personal jurisdiction over a derivative suit. For example, in Delaware, when a director, trustee, or member of a governing body of a Delaware corporation accepts election or appointment, that individual consents to Delaware's jurisdiction over claims arising out of the individuals' acts performed in that individual's capacity as a director, trustee, or member of a governing body of the corporation (10 Del. C. § 3114(a)). The individual agrees to the appointment of the registered agent of the corporation or Delaware's Secretary of State as an agent permitted to accept service on the individual's behalf (10 Del. C. § 3114(a)). Therefore, by bringing a shareholder derivative lawsuit in a Delaware state court, plaintiffs may avoid many of the jurisdictional arguments raised by defendants.

Venue

In the absence of an enforceable forum selection clause, the forum state's venue rules determine where within the forum state a plaintiff must bring a derivative suit (see, for example, *Shapiro v. Rockville Country Club, Inc.*, 802 N.Y.S.2d 717, 720 (N.Y. App. Div. 2d Dept. 2005) and see Impact of Forum Selection Clauses in Derivative Suits).

For example, New York's venue rules generally allow a plaintiff to sue in:

- The county where any of the parties reside when the plaintiff commenced the lawsuit (a corporation is usually deemed to reside in the county where its principal office is located).
- The county designated by the plaintiff, if none of the parties reside in New York State.

(N.Y. C.P.L.R. § 501(a) and (c).)

If the plaintiff brings the derivative suit in federal court, the federal venue rules require the shareholder bringing the derivative suit on behalf of a corporation to bring the suit only in a federal district in which the corporation could sue the defendants itself (*Van Gelder v. Taylor*, 621 F. Supp. 613, 620 (N.D. Ill. 1985); 28 U.S.C. § 1401). Determining where the corporation could sue the defendants is governed by the general federal venue rule (*Van Gelder*, 621 F. Supp. at 620). Therefore, the shareholder may bring the derivative suits (at least those relating to diversity cases) on behalf of the corporation in any judicial district where the defendant resides or where the events giving rise to the claim occurred (28 U.S.C. § 1391(b), (c)).

Impact of Forum Selection Clauses in Derivative Suits

In recent years, corporations have included forum selection clauses in their certificates of incorporation, by-laws, or shareholder agreements. Effective August 1, 2015, Section 115 of the Delaware General Corporation Law (DGCL § 115) authorizes the adoption of a provision in either the certificate of incorporation or the by-laws that requires any or all "internal corporate claims" be brought solely in a Delaware court. Under the statute, the term "internal corporate claims" is defined as "claims, including claims 'in the right of the corporation'" (meaning derivative claims), that either:

- Are based on a violation of a duty by a current or former director, officer, or stockholder in that capacity.

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- Come under the jurisdiction of the Delaware Court of Chancery based on another provision of the DGCL.

Under Section 115, the charter or by-law provision can designate Delaware exclusively, or Delaware and another state. It cannot, however, designate exclusively a state other than Delaware. A forum selection clause that designates a non-Delaware forum is enforceable against a shareholder if included in a shareholder agreement or other writing signed by that shareholder.

The US District Court for the Northern District of California had cast doubt on the enforceability of forum selection by-laws, holding that forum selection clauses in a corporation's by-laws are unenforceable in federal court (*Galaviz v. Berg*, 763 F.Supp.2d 1170, 1174-1175 (N.D. Cal. 2011)). The *Galaviz* court held that because the board amended the corporation's by-laws to include a forum selection clause after the alleged wrongful act occurred, without obtaining the consent of existing shareholders, basic contract principles dictated that the forum selection clause was unenforceable (*Galaviz*, 763 F.Supp.2d at 1174). However, recent decisions in New York, Oregon, Louisiana, Illinois, and California have enforced Delaware forum selection clauses by dismissing wrongfully filed suits. The California decision is particularly notable for distinguishing *Galaviz* and enforcing a by-law that was adopted before the corporation was under threat of dissident activity or litigation (see *Groen v. Safeway Inc.*, 2014 WL 3405752 (Cal. Super., Alameda County, May 14, 2014)).

As a procedural matter, if a plaintiff shareholder wrongfully files suit in a non-Delaware forum in spite of a forum selection by-law, the correct procedure for the corporation is to move to dismiss in that forum, rather than seek an anti-suit injunction in Delaware (see *Edgen Group Inc. v. Genoud*, 2013 WL 6409517 (Del. Ch. Nov. 5, 2013)).

State Contract Law

In addition to the impact of forum selection clauses, state law can also affect the parties' ability to choose the venue and forum in which to bring a shareholder derivative suit. For example, New York permits parties to certain types of contracts with an aggregate transactional value of $250,000 or more to designate New York law as governing, whether or not the contract bears a reasonable relation to New York (N.Y. Gen. Oblig. Law § 5-1401). Where parties to this type of contract have designated New York law as governing and that contract has an aggregate transactional value of $1 million or more, the parties may also designate New York as the governing forum for disputes arising out under the contract (N.Y. Gen. Oblig. Law § 5-1402). For more information about forum selection clauses and limitations on them, see Practice Note, Commencing a Federal Lawsuit: Initial Considerations, Review All Relevant Agreements?.

Choice of Law

Most state courts apply the law of the corporation's state of incorporation to the claims made in a shareholder derivative lawsuit. This is commonly referred as the "internal affairs" doctrine (*Atherton v. FDIC*, 519 U.S. 213, 224 (1997); *Vaughn v. LJ Int'l, Inc.*, 174 Cal.App.4th 213, 223 (Cal. Ct. App. 2d 2009)). The internal affairs doctrine is a choice-of-law principle that calls for state courts to apply the law of the state of incorporation in cases related to corporate governance issues because that state has a superior interest in regulating the internal affairs of corporations organized in that state (*Potter v. Arrington*, 11 Misc.3d 962, 965 (N.Y. Sup. Ct. Monroe Cty. 2006)).

When a plaintiff brings a shareholder derivative action in federal court based on diversity jurisdiction, the federal court applies the forum state's choice-of-law rules when determining the substantive law to apply to the case (*Klaxon Co. v. Stentor Elec. Mfg. Co.*, 313 U.S. 487, 496 (1941)). Because most states follow the internal affairs doctrine, the federal court also usually applies the law of the state of incorporation to the shareholder derivative lawsuit (see, for example, *Fagin v. Gilmartin*, 432 F.3d 276, 282 (3d Cir. 2005)).

Drafting the Shareholder Derivative Complaint

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Many shareholder derivative suits are brought either in federal court or in the Delaware Court of Chancery. As in federal court, the plaintiff initiates a shareholder derivative lawsuit in the Delaware Court of Chancery by filing a complaint (FRCP 3 and Del. Ch. Ct. R. 3). The basic formatting and pleading requirements applicable to civil complaints also apply to shareholder derivative complaints (see FRCP 8; Del. Ch. Ct. R. 8).

A shareholder derivative complaint filed in either the Delaware Court of Chancery or a federal court, however, also has enhanced pleading requirements. Counsel must include:

- Specific allegations that the plaintiff was a shareholder or member at the time of the transaction of which the plaintiff complains or that the plaintiff lost its ownership interest or membership in the corporation by operation of law (Del. Ch. Ct. R. 23.1(a); FRCP 23.1(b)).
- Specific allegations describing the efforts, if any, made by the plaintiff to obtain the action desired from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or that that demand would be futile (Del. Ch. Ct. R. 23.1(a); FRCP 23.1(b)).
- Verification that the shareholder derivative complaint was signed under oath and that the facts alleged in the complaint are true or believed to be true (Del. Ch. Ct. R. 23.1(a); FRCP 23.1(b)).

Responding to the Complaint

After the shareholder derivative action is commenced, the defendants must respond to the plaintiff's complaint (or risk defaulting). Some of the key issues for defendants to consider when responding to a shareholder derivative complaint include:

- Who may respond to the complaint (see Who May Respond to a Shareholder Derivative Complaint).
- When the response is due (see When to Respond to a Shareholder Derivative Complaint).
- The procedural options available to defendants when responding to a shareholder derivative complaint (see Defendant's Response Options).

Who May Respond to a Shareholder Derivative Complaint

Often it is the named defendants to a shareholder derivative lawsuit (which frequently includes the corporation's directors) who respond to the complaint (see, for example, *Weiss*, 948 A.2d at 438). However, where the board has delegated authority to act on a shareholder derivative plaintiff's claims to an SLC, the SLC may respond instead of the named defendants (see *Take-Two Interactive Software, Inc.* ***v***. *Brant*, 2010 WL 1257351, at *1 (S.D.N.Y. Mar. 31, 2010)).

When to Respond to a Shareholder Derivative Complaint

The FRCP and similar state rules determine the amount of time a defendant (or the SLC, when permitted) has to respond to a shareholder derivative complaint. In federal courts, a party must respond to a shareholder derivative complaint within 21 days after being served with the summons and complaint (FRCP 12(a)(1)). State courts provide for different amounts of time to respond to a shareholder derivative complaint. For example, in the Delaware Court of Chancery, a party has 20 days to respond to a complaint after service (Del. Ch. Ct. R. 12(a)). Of course, parties may extend the time to respond to the complaint by stipulation.

Defendant's Response Options

Typically, defendants in a shareholder derivative suit respond to the complaint by filing either an answer or a pre-answer motion, such as a motion to dismiss.

When responding to a derivative complaint by filing an answer, defendants must, in short and plain terms, provide their defenses to each of the plaintiff's claims and admit or deny the allegations asserted in the complaint (FRCP 8(b)(1); Del. Ch. Ct. R. 8(b)). Denials must respond to the substance of the allegations of the complaint (FRCP 8(b)(2); Del. Ch. Ct. R.

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8(b)). Defendants must also provide in the answer to a complaint any relevant affirmative defenses they choose to assert, including:

- Accord and satisfaction.
- Arbitration and award.
- Assumption of risk.
- Contributory negligence.
- Duress.
- Estoppel.
- Failure of consideration.
- Fraud.
- Illegality.
- Injury by fellow servant.
- Laches.
- License.
- Payment.
- Release.
- *Res judicata*.
- Statute of frauds.
- Statute of limitations.
- Waiver.

(FRCP 8(c)(1); Del. Ch. Ct. R. 8(c).)

When making a motion to dismiss, defendants typically assert one or more of the following defenses:

- A lack of subject matter jurisdiction.
- A lack of personal jurisdiction.
- Improper venue.
- Insufficient process.
- Insufficient service of process.
- Failure to state a claim upon which relief can be granted.
- Failure to join a necessary party.

(FRCP 12(b); see also Del. Ch. Ct. R. 12(b).)

In addition, the shareholder derivative pleading requirements for derivative cases under either FRCP 23.1 or similar state rules provide additional bases for dismissal (see, for example, Del. Ch. Ct. R. 23.1). For example, a derivative defendant may move for dismissal based on the plaintiff's failure to:

- Allege it was a shareholder at the time of the challenged transaction.
- Allege it made a demand on the board that the board take a specific corporate action or initiate litigation.
- Verify the complaint.

(See *Desimone v. Barrows*, 924 A.2d 908, 927 (Del. Ch. 2007).)

If the board delegates complete authority to act on a shareholder derivative plaintiff's claims to the SLC, the SLC may decide to move to dismiss a shareholder derivative lawsuit itself based on its own findings (see, for example, *Take-Two Interactive Software, Inc.*, 2010 WL 1257351, at *1). Although technically a motion to dismiss, courts may view a motion based on the SLC report as a motion for summary judgment (*Sutherland v. Sutherland*, 958 A.2d 235, 238 (Del. Ch. 2008)). In deciding whether or not to grant a motion to dismiss filed by an SLC or based on an SLC's recommendations to dismiss the suit, courts generally pay great deference to the SLC's recommendations.

The majority of states have adopted the standard of review formed by Delaware courts. This standard involves a two-step inquiry that requires:

- The corporation to demonstrate that the SLC:
  - was truly independent from the board;
  - acted in good faith; and
  - conducted a reasonable investigation.

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- The corporation applied its own business judgment to determine whether the SLC's recommendation to dismiss the derivative lawsuit was valid.

(*Zapata*, 430 A.2d at 789.)

For more information on Special Litigation Committees, see Practice Note, Shareholder Derivative Litigation: Special Litigation Committees.

If the shareholder plaintiff files an answering brief in opposition to the motion to dismiss, then any dismissal of the derivative action is with prejudice as to the named plaintiff (meaning that the named plaintiff is precluded from re-filing the same claims at a later date), but without prejudice to other potential plaintiffs (Del. Ch. Ct. R. 15(aaa); see *In re EZCORP Inc. Consulting Agreement Derivative Litig.*, 130 A.3d at 941-42).

Discovery in Shareholder Derivative Lawsuits

Discovery in shareholder derivative lawsuits raises several unique issues including:

- The availability of limited discovery in shareholder derivative lawsuits (see Limited Discovery Available in Shareholder Derivative Lawsuits).
- How to access corporate records before filing a shareholder derivative lawsuit (see Pre-Suit Access to Corporate Records).
- Stays of discovery in shareholder derivative lawsuits (see No Automatic Stay of Discovery in Shareholder Derivative Lawsuits Pending Motion to Dismiss).
- Attorney-client privilege considerations (see Privilege Considerations in Shareholder Derivative Lawsuits).

Limited Discovery Available in Shareholder Derivative Lawsuits

Discovery in shareholder derivative lawsuits is usually limited to materials used to:

- Evaluate whether a board was disinterested and independent and acted in good faith and with due care, when reasonably deciding to reject a shareholder's demand (*In re PSE&G S'holder Litig.*, 173 N.J. at 286).
- Assess the independence and good faith of SLC members and the reasonableness of its investigation (***Grimes*** ***v***. *DSC Commc'n Corp.*, 724 A.2d 561, 565 (Del. Ch. 1998)).
- Determine the reasonableness of a settlement agreement (*Polk* ***v***. *Good*, 507 A.2d 531 (Del. 1986)).
- Support objections to a settlement agreement (see, for example, *Ryan* ***v***. *Gifford*, 2009 WL 18143, at *3 (Del. Ch. Jan. 2, 2009)).

Discovery is generally not permitted to assist plaintiffs in satisfying pleading requirements, such as the demand requirement (*Beam* ***v***. *Stewart*, 845 A.2d 1040, 1056 (Del. 2004)). The court's review of a derivative complaint is limited to the facts alleged in the complaint, and plaintiffs may not use discovery to supplement their pleadings to assist with their compliance with the pleading requirements for derivative lawsuits (*In re Merck & Co., Inc. Sec., Deriv. & ERISA Litig.*, 493 F.3d 393, 397 (3d Cir. 2007)).

Pre-Suit Access to Corporate Records

Although discovery in shareholder derivative suits is limited, certain states give shareholders the right to access a corporation's records on demand even without filing suit. For example, Delaware law permits shareholders to access a corporation's stock ledger, list of stockholders, and various other kinds of documents if the request is reasonably related to the person's interest as a stockholder (DGCL § 220(b)). The Delaware Court of Chancery has held that pre-suit access to a corporation's books and records may be necessary for the plaintiffs to satisfy the particularized demand requirement (***Grimes*** ***v***. *DSC Commc'n Corp.*, 724 A.2d at 565; *Thermopylae Capital*

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P'rs, L.P. v. Simbol, Inc., 2016 WL 368170 at *17 (Del. Ch. Jan. 29, 2016)). If the corporation denies access, the shareholder may sue in the Court of Chancery to compel the production of those documents (DGCL § 220(c)). For further discussion of books and records demands under Delaware law, see Standard Document, Stock Ledger: Drafting Note, Inspection of the Stock Ledger and Other Records Under Delaware Law.

No Automatic Stay of Discovery in Shareholder Derivative Lawsuits Pending Motion to Dismiss

There is no automatic stay of discovery pending a court's decision on a motion to dismiss a shareholder derivative lawsuit (*Orloff v. Shulman*, 2005 WL 333240, at *1 (Del. Ch. Feb. 2, 2005)). This practice differs from other types of corporate litigation, such as certain federal securities fraud suits, where discovery is typically stayed after the defendant files a motion to dismiss (15 U.S.C. § 78u-4(b)(3)(B)). To obtain a stay of discovery in a derivative lawsuit pending resolution of a motion to dismiss, a party should file a motion to stay discovery, which the court will decide in its sound discretion (*Orloff*, 2005 WL 333240, at *1).

Privilege Considerations in Shareholder Derivative Lawsuits

Corporations may attempt to invoke the attorney-client privilege to avoid producing corporate records to shareholders, such as books and records under Section 220 of the Delaware General Corporation Law. A shareholder who asserts that the corporation has acted against shareholder interests may still access documents from the corporation despite a privilege claim if the shareholder shows good cause as to why the privileges should not apply (*Garner v. Wolfinbarger*, 430 F.2d 1093, 1104 (5th Cir. 1970)). The *Garner* exception has been explicitly endorsed by the Delaware Supreme Court (*Wal-Mart Stores, Inc. v. Indiana Elec. Workers Pension Trust Fund IBEW*, 95 A.3d 1264, 1278 (Del. 2014)).

When evaluating whether the plaintiff has shown good cause and is entitled to inspect corporate records despite a claim for privilege, courts examine several factors, including:

- The number of shareholders.
- The percentage of stock the shareholders own.
- The shareholders' bona fides.
- The nature of the shareholders' claim.
- The necessity or desirability of shareholders receiving the information.
- The availability of information from other sources.
- Whether the alleged wrongdoing is illegal, criminal, or of doubtful legality.
- Whether the alleged wrongdoing relates to past or prospective actions.
- Whether the communication sought concerns the litigation itself.
- The extent to which the information requested is identified and not just a fishing expedition.
- The risk of revealing trade secrets or other information that is independently confidential.

The good cause exception as set in *Garner* generally may not be used to defeat a claim of work product protection (see *Teleglobe USA, Inc. v. BCE Inc. (In re Teleglobe Commc'ns Corp.)*, 392 B.R. 561 (Bankr. D. Del. 2008); *Lawrence E. Jaffee Pension Plan v. Household Int'l. Inc.*, 244 F.R.D. 412 (N.D. Ill. 2006)). However, the *Wal-Mart* decision did adopt *Garner* as an exception to the work product doctrine as well.

For information about shareholders' ability to access otherwise confidential communications, see Practice Note, Attorney-Client Privilege: Identifying the Attorney and the Client: Access to Privileged Communications under Garner and the "Fiduciary Exception."

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Settling the Shareholder Derivative Lawsuit

The parties in a derivative suit often settle the case instead of going to trial. The court must approve the settlement agreement resolving a shareholder derivative lawsuit (see Del. Ch. Ct. R. 23.1(c); FRCP 23.1(c)). In addition, the court will order a manner to provide notice of the settlement to shareholders or members (Del. Ch. Ct. R. 23.1(c); FRCP 23.1(c)). There are several issues related to settlement in the shareholder derivative suit context counsel should consider, including:

- What factors courts consider in deciding whether to approve a settlement (see Factors Considered in Approving Settlement).
- How to notify shareholders of the proposed settlement (see Notice to Shareholders of Settlement).
- Shareholders' rights to challenge a settlement (see Shareholders' Right to Challenge a Settlement).

Factors Considered in Approving Settlement

The party proposing the settlement of a shareholder derivative lawsuit bears the burden of establishing that the settlement agreement is fair, adequate, reasonable, and in the best interests of the corporation (*Maher* ***v***. *Zapata Corp*., 714 F.2d 436, 454 (5th Cir.1983)). The court may approve or reject a settlement agreement in its discretion by evaluating:

- The facts and circumstances of the case.
- The nature of the asserted claims and defenses.
- The fairness of the settlement after applying its own business judgment.

(*In re Countrywide Corp. S'holders Litig*., 2009 WL 846019, at *6 (Del. Ch. Mar. 31, 2009).)

When evaluating the fairness of the terms of a proposed settlement agreement, courts generally consider:

- The likelihood of success of the claims in the shareholder derivative complaint.
- The complexity, expense, and likely duration of the litigation.
- The ability to collect on the judgment.
- The value of the settlement compared to the value of a potential judgment in the lawsuit.
- The stage of the litigation.
- The appearance of only a few objectors to the agreement.

(See *Polk*, 507 A.2d at 536; *Bell Atl. Corp.* ***v***. *Bolger*, 2 F.3d 1304, 1311 (3d Cir. 1993).) Specifically in the realm of derivative actions brought over public merger deals, the Delaware Court of Chancery has warned that it will be "increasingly vigilant" when scrutinizing the "give" and "get" of settlements that propose to trade a global release of all known and unknown claims in return for supplemental disclosures to the shareholders (*In re Trulia, Inc. S'holder Litig*., 129 A.3d 884 (Del. Ch. 2016)). The *Trulia* court cautioned that it will expect that any supplemental disclosures address a "plainly material" misstatement or omission in the proxy statement in return for a narrowly tailored release that encompasses only disclosure claims and fiduciary duty claims concerning the sale process.

As a result of the *Trulia* decision and its progeny, plaintiffs increasingly file complaints challenging a company's merger based on claims of misleading proxy statements in federal courts (see, for example, *Rosenfeld* ***v***. *Time Inc*., 2018 WL 4177938, at *1-2 (S.D.N.Y. Aug. 30, 2018)). To the extent these claims may be derivative, plaintiffs should review the *Trulia* decision before filing in Delaware Chancery Court. Counsel planning to file in federal court should also review the relevant recent decisions of the federal court in which they plan to file to determine whether the court has adopted the *Trulia* approach.

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Notice to Shareholders of Settlement

Shareholders must receive notice of any proposed settlement because, unlike in the class action context, they do not have the right to opt out of any settlement of a shareholder derivative lawsuit (FRCP 23.1; Del. Ch. Ct. R. 23.1).

Notice of a settlement in a shareholder derivative action must be provided to all shareholders in a manner ordered by the court (see *Maher*, 714 F.2d at 450-51). Courts have broad discretion to approve the form and content of the notice of settlement. It is generally sufficient for the notice to make the stockholders aware of the general nature of the subject matter and warn them that their substantial interests are involved. The notice of settlement should therefore include:

- The nature of the pending action.
- The claims asserted in the action.
- The general terms of the proposed settlement.
- The availability of additional materials from the court.
- The time and place of the settlement hearing.
- The shareholders' right to participate.

(*Maher*, 714 F.2d at 451).

Shareholders' Right to Challenge a Settlement

Although shareholders do not have the right to opt out of a settlement in a derivative action, they do have the right to object to the settlement (*Zimmerman*, 800 F.2d at 391). Courts consider multiple factors when deciding whether or not to approve a proposed settlement, including:

- The probable validity of claims.
- The apparent difficulties in enforcing the claims through the courts.
- The collectability of any judgment recovered.
- The delay, expense, and trouble of litigation.
- The amount of the compromise, as compared with the amount and collectability of a judgment.
- Any shareholders' objections.

(*Polk*, 507 A.2d at 536).

In considering these factors, the standard of review for a Delaware court is "whether the settlement falls within a range of results that a reasonable party in the position of the plaintiff, not under any compulsion to settle and with the benefit of the information then available, reasonably could accept" (*Forsythe **v**. ESC Fund Mgmt. Co. (U.S.)*, 2013 WL 458373, at *2 (Del. Ch. Feb. 6, 2013); *In re Activision Blizzard Inc. S'holder Litig.*, 124 A.3d at 1064). Ordinarily, if the representative plaintiff was independent and lacking in any self-interest, the settlement will be upheld without incident. However, if the representative negotiates any unique and personal benefits for itself, it may undercut the appearance of fairness that is necessary to approve the settlement. For example, a representative plaintiff's special deal with the company to buy back illiquid shares held by the representative is grounds for rejecting an otherwise strong settlement agreement (see *Smollar **v**. Potarazu*, 2016 WL 206288 (Del. Ch. Jan. 14, 2016)).

Shareholders objecting to a proposed settlement usually lodge any objection to a proposed settlement after receiving notice of the settlement (*Maher*, 714 F.2d at 450). For example, the court in *Mayer* issued a notice of a proposed settlement of a derivative action instructing shareholders of the date, time, and location of a hearing to determine whether to accept a proposed settlement so that shareholders could show cause on why the settlement should be rejected (*Maher*, 714 F.2d at 450).

Security for Costs

Many states allow a defendant to a shareholder derivative lawsuit to request that the shareholder plaintiff post security for costs if the lawsuit fails (see,

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for example, N.Y. Bus. Corp. Law § 627, N.Y. C.P.L.R. § 8501, and Cal. Corp. Code § 800). The key issues concerning the ability of a party to move for security for costs in shareholder derivative lawsuits are addressed by examining:

- The legal basis for security for costs in shareholder derivative lawsuits (see Legal Basis for Security for Costs in Derivative Lawsuits).
- Reasons to permit security for costs (see Reasons to Permit Security for Costs).
- How to obtain security for costs (see How to Obtain Security for Costs in Shareholder Derivative Litigation).
- How to post the security (see How to Post the Security).
- Limits on the security for costs requirement (see Limits on Security for Costs).
- The consequences of not complying with an order to post security for costs (see Compliance with Order to Post Security for Costs).

Legal Basis for Security for Costs in Derivative Lawsuits

Certain states allow a defendant to request the shareholder plaintiff to post a security for litigation costs or expenses should the plaintiff be unsuccessful in the derivative litigation (for example, Cal. Corp. Code § 800; N.Y. Bus. Corp. Law § 627; Del. Ch. Ct. R. 3(c)). Some states permit the security to cover attorneys' fees (see, for example, *West Hills Farms, Inc. v. RCO AG Credit, Inc.*, 170 Cal.App.4th 710, 717 (Cal. Ct. of App., 5th Dist. 2009); N.Y. Bus. Corp. Law § 627).

Reasons to Permit Security for Costs

Courts permit defendants to move for security for costs to deter the abuse of shareholder derivative lawsuits and the filing of "strike suits" brought only to obtain a settlement from a corporation and other vexatious litigation (*Cohen*, 337 U.S. at 548; *Donner Mgmt. Co. v. Schaffer*, 142 Cal.App.4th 1296, 1305 (Cal. Ct. of App. 4th Dist. 2006)).

How to Obtain Security for Costs in Shareholder Derivative Litigation

To obtain security for costs in shareholder derivative litigation, a defendant typically makes a motion for the plaintiff to post the security (for example, Cal. Corp. Code § 800(c)). Some states, like California, require that the defendant bring a motion for security for costs within 30 days after service of process (Cal. Corp. Code § 800(c)). Meanwhile, the Delaware Court of Chancery may order a plaintiff who is an out-of-state resident to post the security on a defendant's motion after five days' notice (Del. Ch. Ct. R. 3(c)). Other states, like New York, require only that the motion be made before final judgment (N.Y. Bus. Corp. Law § 627).

To obtain security for costs, some states require the defendant to demonstrate that:

- The derivative lawsuit will likely not provide any benefit to the corporation or shareholders.
- The defendants did not participate in the challenged transaction.

(For example, Cal. Corp. Code § 800(c).)

However, Delaware does not have a similar security for costs statute.

How to Post the Security

When the court orders a party to post the security in a shareholder derivative lawsuit, that party furnishes the security in a manner ordered by the court or by statute (see, for example, *Donner Management Co.*, 142 Cal.App.4th at 1305). The security may take the form of a secured bond furnished by the plaintiff to the court in an amount the court sets under the circumstances of the individual case (S.D.N.Y. and E.D.N.Y. L. Civ. R. 54.2).

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Limits on Security for Costs

Although a defendant may move the court to order the plaintiff to provide security for costs associated with derivative litigation, courts have placed limitations on both the amount of the security and who must post security for costs. These limitations include:

- In California, the plaintiff may be required to furnish a bond not exceeding $50,000 (*West Hills Farms, Inc.*, 170 Cal.App.4th at 717).
- In New York, plaintiffs owning 5% or more of the outstanding shares of a corporation or whose share of the corporation is valued at more than $50,000 are not required to post security for defense costs (N.Y. Bus. Corp. Law § 627).
- In Delaware, under the rules of the Delaware Court of Chancery, only out-of-state plaintiffs may be required to post security for costs in shareholder derivative suits with five days' notice to the plaintiff (Del. Ch. Ct. R. 3(c)).

Compliance with Order to Post Security for Costs

Failure to provide security for defense costs may result in dismissal of the shareholder derivative lawsuit on the motion of the defendant (see, for example, *Singh v. Lipworth*, 132 Cal.App.4th 40, 47 (Cal. Ct. of App. 3d Dist. 2005)).

Remedies in Shareholder Derivative Litigation

Remedies in shareholder derivative litigation are unique because they usually go to the corporation on whose behalf the plaintiffs brought suit, rather than the named plaintiffs themselves (see Distinction between Derivative and Direct Lawsuits). Considerations include:

- The type of remedies available in shareholder derivative litigation (see Types of Remedies Available in Shareholder Derivative Litigation).
- The availability of attorneys' fees in shareholder derivative litigation (Attorneys' Fees in Shareholder Derivative Litigation).
- The role insurance policies play in shareholder derivative litigation (see Role of Insurance Policies in Shareholder Derivative Litigation).

Types of Remedies Available in Shareholder Derivative Litigation

The remedies available in shareholder derivative litigation include both:

- Compensatory and punitive damages that accrue to the corporation (*Kalin*, 526 F. Supp. 2d, at 407).
- Equitable relief, such as an injunction or declaratory relief (*Kalin*, 526 F. Supp. 2d, at 408).

In addition, plaintiffs may also obtain nonmonetary benefits on behalf of the corporation, usually through settlement, including:

- Structural changes in a corporation's governance affecting the implementing of marketing programs (*Bell Atlantic Corp.*, 2 F.3d at 1311).
- Changes in corporate governance aimed at limiting a corporation's disbursements to a director and controlling shareholder (*Granada Investments, Inc. v. DWG Corp.*, 962 F.2d 1203, 1207 (6th Cir. 1992)).
- A set of instructions to be followed in the event of a future tender offer or takeover bid (*Zimmerman*, 800 F.2d at 391).

Attorneys' Fees in Shareholder Derivative Litigation

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Normally, in the US, the party who loses a lawsuit is not required to pay the winning side's attorneys' fees. Shareholder derivative suits are an exception to this rule (*Seinfeld v. Coker*, 847 A.2d 330, 335 (Del. Ch. 2000)). The availability of attorneys' fees in shareholder derivative litigation is addressed by examining:

- The common fund doctrine (see Common Fund Doctrine).
- The substantial benefit doctrine (see The Substantial Benefit Doctrine).
- How to calculate attorneys' fees (see How to Calculate Attorneys' Fees).

Common Fund Doctrine

The common fund doctrine provides for litigants to receive their attorneys' fees if:

- The action was meritorious at the time it was filed.
- An ascertainable group received a substantial benefit.
- A causal connection existed between the litigation and the benefit.

(*Dover Historical Soc'y, Inc. v. City of Dover Planning Comm'n*, 902 A.2d 1084, 1089 (Del. 2006).)

If the attorney recovers a common fund from the settlement of a shareholder derivative lawsuit, the attorney may then independently request an award of fees from that fund (*Seinfeld*, 847 A.2d at 335). Any fee awarded must be reasonable in light of:

- The outcome of the lawsuit (the factor assigned the greatest weight).
- The time and efforts taken by the attorney.
- The relative complexity of the litigation.
- The contingent nature of the attorney's fee.
- The attorney's skill in litigating the claim.

(*In re Abercrombie & Fitch Co. S'holder Deriv. Litig.*, 886 A.2d 1271 (Del. 2005).) These considerations are known as the "Sugarland factors" after the decision in which they were first articulated (*Sugarland Indus., Inc. v. Thomas*, 420 A.2d 142 (Del. 1980)).

The Substantial Benefit Doctrine

The court may also award attorneys' fees under a corollary to the common fund doctrine, the substantial benefit doctrine. The substantial benefit doctrine permits an award of attorneys' fees where no common fund was created, but the plaintiff had meritorious claims and the attorney's efforts provided a substantial benefit to the corporation (*Julian v. E. States Const. Serv., Inc.*, 2009 WL 154432, at *2 (Del. Ch. Jan. 14, 2009)). The benefit to the corporation may be a financial benefit or take the form of a non-quantifiable benefit, including:

- Improved internal controls.
- Better training practices.
- An increased number of independent directors.
- Enhanced shareholder removal power.

(See, for example, *In re Rambus Inc. Deriv. Litig.*, 2009 WL 166689, at *3 (N.D. Cal. Jan. 20, 2009).)

How to Calculate Attorneys' Fees

Courts, at their discretion, calculate attorneys' fees depending on the type of benefit the corporation receives from the settlement of a shareholder derivative lawsuit and the facts of the lawsuit.

When the benefit to the corporation is quantifiable, courts usually apply the "percentage of the benefit" approach when determining the award of attorneys' fees (*Julian*, 2009 WL 154432, at *2). Under this approach, courts analyze the benefit to the corporation and the efforts and skill of the attorney to determine a reasonable percentage rate and then multiply the total quantifiable benefit by that rate to determine the award of attorneys' fees (*Franklin Balance Sheet Inv. Fund v. Crowley*, 2007 WL 2495018, at *12 (Del. Ch. Aug. 30, 2007)). When a case settles early, courts tend to award 10-15% of the monetary benefit conferred. When a case settles after the plaintiffs have engaged

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in meaningful litigation efforts, fee awards range from 15-25% of the monetary benefits conferred. Higher percentages are warranted when cases progress to trial, but 33% is considered the very top of the range. (*Ams. Mining Corp. v. Theriault*, 51 A.3d 1213, 1259-1260 (Del. 2012).)

When the benefit to the corporation is unquantifiable, courts apply the lodestar approach to determine the award of attorneys' fees (*Seinfeld*, 847 A.2d at 335). The lodestar approach calculates attorneys' fees by multiplying the reasonable amount of hours an attorney has expended on the litigation and a reasonable hourly rate (*Seinfeld*, 847 A.2d at 335). The court can then add a multiplier to that amount to account for factors such as the quality of the attorney's work (*Seinfeld*, 847 A.2d at 335).

Once the court makes an independent determination of the reasonableness of a range for the attorneys' fees, it will show deference to any fee negotiated between the parties that falls within that range (*In re Activision Blizzard Inc. S'holder Litig.,* 124 A.3d at 1075).

Role of Insurance Policies in Shareholder Derivative Litigation

Because of the high costs associated with defending and settling shareholder derivative lawsuits, directors and officers, as well as companies, should obtain **directors and officers liability insurance** (D&O insurance). D&O insurance protects directors and officers from losses suffered because of their service to a company. It may also pay corporations to indemnify directors and officers from losses suffered because of their service to the corporation. These policies are important because of:

- The types of D&O coverage available (see Types of Directors and Officers Coverage).
- The limits on D&O coverage (see Limits on Directors and Officers Coverage).

Types of Directors and Officers Coverage

The three most common types of D&O coverage serve to:

- Protect directors and officers from personal loss resulting from conduct arising out of their duties to the corporation (Side A Coverage).
- Reimburse the corporation for indemnifying directors and officers for claims made against them (Side B Coverage).
- Reimburse the corporation for certain claims made directly against it (Side C Coverage).

Limits on Directors and Officers Coverage

D&O insurance provides coverage only for covered losses. Covered losses usually only include:

- Damages.
- Judgments.
- Settlements.
- Defense costs.

D&O policies often expressly exclude coverage for punitive or exemplary damages. Although a corporation may attempt to negotiate for coverage of punitive damages, some jurisdictions have laws barring coverage for punitive damages.

Other exclusions usually included in D&O policies are:

- The conduct exclusion.
- The fines, penalties, and ill-gotten gains exclusion.
- The prior litigation or prior claims exclusion.
- The insured versus insured exclusion.

For information about D&O insurance policies, see Practice Note, Directors and Officers Liability Insurance Policies.

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Balotti and Finkelstein's Delaware Law of Corporations and Business Organizations

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Volume 1

Chapter 4: Directors and Officers

Part One: Statutory Provisions

§ 4.10 DELEGATION BY A BOARD OF DIRECTORS

[A] Delegation Generally

The board's power to delegate is broad, although a board "may not either formally or effectively abdicate its statutory power and its fiduciary duty to manage or direct the management of the business and affairs of [the] corporation." [189] The Delaware Supreme Court has explained that, "[w]ith certain exceptions, 'an informed decision to delegate a task is as much an exercise of business judgment as any other."DD' [190] Unless otherwise provided by the certificate of incorporation and subject to the limitation on delegation set forth in the General Corporation Law, [191] a board of directors may delegate the management of the business and affairs of the corporation. [192]

In 1956, the Delaware Supreme Court held that "[t]he general rule forbidding the directors to delegate managerial duties applies as well to a delegation of a single duty as to the delegation of several or of all duties." [193] This strict rule was relaxed by the 1974 Amendment to Section 141(a) of the General Corporation Law. In 1956, Section 141(a) had provided that "the business and affairs of every corporation organized under this chapter shall be managed by a board of directors." In 1974, after several intervening changes, this section was amended to conform more closely (but not exactly) to the Model Act: "The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation." [194]

The Court of Chancery has expressed the view that the 1974 Amendment "was simply a refinement that clarified a point hardly in need of very much clarification. Prior to the amendment it was clear

that a board of directors could meet its management responsibilities by appropriately appointing and monitoring, corporate officers and exercising informed business judgment with respect to corporate goals and performance." [195] In describing the contemporary division of responsibility, the Court explained that, although the board of directors has the "ultimate responsibility" for managing today's large, complex enterprises, "the law recognizes that corporate boards, comprised as they traditionally have been of persons dedicating less than all of their attention to that role, cannot themselves manage the operations of the firm, but may satisfy their obligations by thoughtfully appointing officers, establishing or approving goals and plans and monitoring performance." [196]

If the board of directors has a specific duty, whether by virtue of the certificate of incorporation or a statute, to exercise its own discretion, it may not delegate the exercise of that discretion except to a board committee created pursuant to Section 141(c), if the subject matter does not fall within the exceptions of that subsection. This is consistent with the general law on the subject. [197] Thus, in 1969, the Court of Chancery held that a board of directors could not delegate to officers the responsibility of fixing the terms and conditions of a sale of assets because, under Section 271, such a determination is expressly a duty to be fulfilled by the board. [198] Likewise, in 1949, the Court of Chancery had held that a board of directors may not delegate the duty of determining the value of property acquired as consideration for the issuance of stock because Section 152 of the General Corporation Law provides that this duty is expressly assigned to the board. [199] The cases vary on what constitutes an excessive delegation generally, but they are reasonably consistent in holding that, where a specific authority is vested in the board of directors, it may not be delegated. [200] Moreover, it has been observed that "a director breaches his fiduciary duty of due care if he abdicates his managerial duties." [201]

The term "management," however, is deemed to encompass "supervision, direction and control," while "the details of the business [may be] delegated to inferior officers, agents and employees." [202] Most modern corporations are run by the officers on a day-to-day basis. These responsibilities go beyond the purely ministerial acts that directors "may unquestionably delegate." [203] Indeed, the "necessities of the case and usage" contemplate that many discretionary acts will be carried out by officers and other subordinates. [204] Such powers are often implied from course of conduct, rather than being expressly granted. [205] Thus, as noted above, """"[a]n informed decision to delegate a task is as much an exercise of business judgment as any other." [206]

The Court of Chancery has noted that the board of directors "bears the ultimate duty to manage or supervise the management of the business and affairs of the corporation" and that this typically "entails the duty to establish or approve the long-term strategic, financial and organizational goals of the corporation; to approve formal or informal plans for the achievement of these goals; to monitor corporate performance; and to act, when in the good faith, informed judgment of the board it is appropriate to act." [207] These responsibilities may be "satisfied in various ways and with varying degrees of formality," the Court stated, but "it is essential that the members of the board understand that it is with the board and not with the officers of the corporation that ultimate responsibility lies." [208] Further, "directors need to be active and reasonably informed when overseeing the sale process, including identifying and responding to actual or potential conflicts of interest." [209]

[B] Committees of the Board and Their Powers

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Certain duties may be assigned or delegated to officers, employees, or agents, but not powers vested exclusively in the board. Often the board will delegate its powers to, or will act through, committees established pursuant to Section 141(c) of the General Corporation Law. Section 141(c) grants the board of directors of a Delaware corporation the power to designate committees of the board to exercise certain of the broad powers and authority of the board in the management of the business and affairs of the corporation. [210] Under Section 141(d), as amended in 2007, when a provision of the certificate of incorporation grants certain directors greater or lesser voting power than other directors, the differentiation of voting power applies both in voting by the board of directors and in voting by committees of the board and subcommittees, unless otherwise provided in the certificate of incorporation or by-laws.

There are committees of the board [211] and other committees of the corporation. Committees created under Section 141(c) to act for the board may be composed only of members of the board. [212] Committees that are purely advisory to the board may include other persons. [213] A board may consider it appropriate to create such a committee to advise the board on a variety of important issues, such as defenses to a hostile takeover, demands by shareholders to institute derivative suits, [214] strategic planning, and the like. [215] It may nevertheless be desirable that the committee be composed of only members of the board of directors, but that is not a requirement if the committee is to function purely as an advisory committee without any power to act for the board. In that case it would be considered merely as a committee of the corporation, not a committee of the board.

Only committees of the board established pursuant to Section 141(c) may be delegated powers to act for the board in matters on which otherwise only the board could act. Even then, as is noted below, there are statutory limits on what may be delegated to a board committee. With limited exceptions, by a resolution passed by a majority of the whole board, the board may delegate to a committee all of the board's power and authority in managing the business and affairs of the corporation. [216] Typical committees include executive, finance, audit, compensation, and nominating committees. The nominating committee, the compensation committee, and the audit committee are "overview" committees. [217] It is considered good corporate practice to have a standard procedure for overview committees to report regularly to the board on their meetings. [218]

Since the audit and compensation committees perform much of the board's most important management monitoring, their effectiveness depends on the extent to which they are made up of non-management directors. [219] Although the General Corporation Law does not require that the board create such committees or appoint only non-management directors, public companies must appoint independent directors to their audit and compensation committees. [220] The same is not always true with respect to nominating committees, but there is a growing trend in that direction. Committees composed of outside directors often have been used to evaluate transactions or issues potentially infected by management self-interest. [221] Issues relating to special committees of directors are discussed elsewhere in this Treatise.

A by-law purporting to authorize the chairman of a committee to appoint a substitute to act for a committee member at a committee meeting in place of an absent or disqualified member may be of questionable validity. Sections 141(c)(1) and (2) specifically provide procedures for the designation of alternate members of committees, permitting the board to designate in advance the alternate members to replace an absent or disqualified member: "The board may designate 1 or more directors as alternate members of any committee, who may replace any absent or disqualified member at any meeting of the committee." [222] In addition, Sections 141(c)(1) and (2) permit the by-laws to set forth a specific procedure whereby the remaining committee members present at the meeting unanimously appoint an alternate: a corporation's by-laws may

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provide that the member or members of a committee "present at any meeting and not disqualified from voting, whether or not such member or members constitute a quorum, may unanimously appoint another member of the board of directors to act at the meeting in the place of any such absent or disqualified member." [223] The specificity of these procedures suggests that by-laws implementing the procedures outlined in Sections 141(c)(1) and (2) probably should not deviate from the procedure authorized.

Section 141(c)(1) provides that a board committee may be granted full powers of the board, subject to certain specific exceptions--(1) the committee may not be empowered to amend the by-laws or to recommend to shareholders an amendment to the certificate of incorporation, a merger, [224] a sale of all or substantially all of the corporation's assets, or a dissolution; and (2) only if the resolution expressly so empowers the committee may it (i) act for the board in declaring a dividend, (ii) fix preferences or rights of certain classes of stock, or (iii) approve a certificate of ownership in a Section 253 short-form merger of a 90 percent-owned subsidiary. [225] The provisions of Section 141(c)(1) govern all corporations incorporated before July 1, 1996, unless such a corporation elects by resolution adopted by a majority of the whole board to be governed by Section 141(c)(2). [226]

Section 141(c)(2), [227] added by amendment in 1996, substantially broadens the power and scope of board committees. This provision automatically applies to all corporations incorporated after July 1, 1996, though corporations incorporated before that date may avail themselves of these provisions by affirmative election. Under Section 141(c)(2), any board committee, to the extent provided in the bylaws or resolutions, "shall have and may exercise all the powers and authority of the board of directors in the management of the business and affairs of the corporation" with two significant exceptions: (1) a committee cannot approve or adopt, or recommend to stockholders, any action or matter expressly required by the General Corporation Law to be submitted to stockholders for a vote; and (2) a committee cannot adopt, amend, or repeal any by-law. [228]

For companies incorporated before July 1, 1996, that have not by resolution elected to be governed by the provisions of Section 141(c)(2), the matter of delegation to a board committee in connection with so-called "blank stock" or "blank check preferred" under Sections 141(c)(1) and 151(g) requires special care. In 1983, Section 141(c) was amended to make clear that a committee of the board of directors may (a) be empowered by a resolution of the board of directors to fix the preferences and rights of stock (with the exception of voting rights that must be established by the board of directors itself) to be issued pursuant to Section 151(g) and the authority granted the directors in the certificate of incorporation; [229] and (b) adopt certificates of ownership and merger pursuant to Section 253 respecting mergers between a parent and a subsidiary at least 90 percent of the outstanding stock of each class of which is owned by the parent. [230]

In 1985, Section 141(c) (now Section 141(c)(1)) was amended to provide that a board committee may also be given the power to fix the designation of shares of blank stock and the number of shares in a series of such stock to the extent authorized by the board in the resolution or resolutions providing for the issuance of such stock. [231] The use of certificates of designations by committees of the board can help the board obtain required corporate financing through the use of special classes or series of stock. [232] As timing is often a crucial factor in issuing such securities, the board's ability to authorize one of its committees to fill in the blanks (with the exception of voting rights) of the new stock provides a simpler way of raising capital than the time-consuming methods involving either the holding of a board meeting or the soliciting of stockholders to fix the necessary terms.

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Among the determinations that may be delegated to a committee are the fixing of the preferences and rights of such shares relating to dividends, redemption, dissolution, asset distributions, or rights relating to conversion or exchange or such shares for other shares of stock of the corporation. Voting rights are considered so important that the entire board should determine them, especially since fractional, scaled, time-phased, or multiple voting rights can be provided. It would be wise for the board resolution delegating any such authority to a committee to be very specific in its description of the committee's precise duties. [233]

[C] Officers

A corporation can act only through its agents. [234] Officers are the principal agents of the corporation. There may, of course, be delegation to other agents--outside experts, independent contractors, or non-officer employees [235] --but normally it is the officers to whom the primary functions of management are delegated. [236] Nonetheless, "[d]irectors may not delegate duties which lie 'at the heart of the management of the corporation."DD' [237]

The offices of the corporation may be prescribed in the by-laws, or they may be set forth in a resolution of the board. [238] Any such resolution must not be inconsistent with the by-laws, the certificate of incorporation, or the General Corporation Law. The persons elected or appointed to office are selected by the board and serve at the pleasure of the board. [239]

The General Corporation Law was not always this liberal. In the 1967 revision there were only minor changes to the prior statute, which had prescribed specific offices--"a president, secretary and treasurer" and "such other officers and agents as are desired." The 1970 Amendment broke the mold and provided the flexibility found in the present version of Section 142, [240] permitting a wide variety of corporate models. Thus, a corporation presently need not have any particular form or titles in its officer structure (except that certain minimum functions, such as keeping the minutes, must be maintained). [241] A corporation need not have a president or a vice president or a secretary or a treasurer, as such; it could have a "czar" or a """"potentate" and a "recordkeeper." This style has not yet come into vogue, though, and more traditional titles seem to prevail. More important than titles and functions of various officers is the express or implied power of each office, the extent to which delegation by the board may be accomplished, and the responsibility of the board in carrying out its oversight function to see that the "business and affairs" of the corporation are carried out "under [its] direction." [242]

Few authorities deal with the nature of the obligation owed by officers to the corporation and its stockholders. The Delaware Supreme Court held in 2009 that "officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty, and that the fiduciary duties of officers are the same as those of directors." [243] The Court also has employed agency principles when discussing duties owed by non-director employees. [244] Similarly, common law duties, such as obligations regarding the use of corporate information, have been imposed on officers as well as directors. [245] Although it has been suggested in dicta that decisions of executive officers may be protected by the business judgment rule, [246] there has been debate on this point. [247]

Footnotes

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a1 **Blake K. Rohrbacher** is an associate of Richards, Layton & Finger. Mr. Rohrbacher is a graduate of Yale Law School, where he served as Executive Editor of the Yale Law Journal.

189 *Grimes v. Donald*, C.A. No. 13358 (Del. Ch. Jan. 11, 1995), slip op. at 17, *aff'd*, 673 A.2d 1207 (Del. 1996).

190 *Grimes v. Donald*, 673 A.2d 1207, 1214 (Del. 1996).

191 *See* 8 *Del. C.* § 141(c).

192 *Lehrman v. Cohen*, 222 A.2d 800, 808 (Del. 1966); *Adams v. Clearance Corp.*, 121 A.2d 302, 305 (Del. 1956); *see also Schoonejongen v. Curtiss-Wright Corp.*, 143 F.3d 120 (3d Cir. 1998) (citing Treatise).

193 *Adams v. Clearance Corp.*, 121 A.2d 302, 305 (Del. 1956).

194 The Committee that drafted and recommended the 1974 Amendment provided the following commentary: "This amendment to Section 141(a) makes explicit the present law that the duty of directors to manage the corporation may be carried out by officers and employees under the direction of the board. Thus, the director's role is formulating policy and directing officers to conduct the day to day operations." *See also Grimes v. Donald*, C.A. No. 13358 (Del. Ch. Jan. 11, 1995), slip op. at 17 n.6 (citing Treatise), *aff'd*, 673 A.2d 1207 (Del. 1996). *But see In re Bally's Grand Derivative Litig.*, C.A. No. 14644 (Del. Ch. June 4, 1997), slip op. at 14 (refusing to dismiss a claim of improper delegation where Bally's board entered into a management agreement with a subsidiary enabling the subsidiary to operate Bally's casino free from interference subject only "'to exercise of the fiduciary duties under applicable law of [Bally's] Board of Directors"DD').

195 *Grimes v. Donald*, C.A. No. 13358 (Del. Ch. Jan. 11, 1995), slip op. at 17 n.6 (citing Treatise), *aff'd*, 673 A.2d 1207 (Del. 1996).

196 *Grimes v. Donald*, C.A. No. 13358 (Del. Ch. Jan. 11, 1995), slip op. at 17 n.6 (citing Treatise), *aff'd*, 673 A.2d 1207 (Del. 1996).

197 *See* 2 William Meade Fletcher, *Cyclopedia of the Law of Private Corporations* § § 495-499 (perm. ed. rev. vol. 1990).

198 *Clarke Mem'l Coll. v. Monaghan Land Co.*, 257 A.2d 234 (Del. Ch. 1969).

199 *Field v. Carlisle Corp.*, 68 A.2d 817, 820 (Del. Ch. 1949) ("Neither the statutes nor the certificate contain any language purporting to authorize the delegation of this duty. Leaving aside other contentions, I do not believe the power to delegate this vitally important duty can be fairly implied from the language of the statute. This is particularly true where the statute imposes the duty on the directors to deal with the particular subject matter. The importance to the corporation of the subject matter--ownership of the corporation--tends also to negate any implication that the directors might delegate it in a manner not explicitly authorized by statute.").

200 *See Nagy v. Bistricer*, 770 A.2d 43 (Del. Ch. 2000) (holding that a board violated its duty under Section 251 by executing a merger agreement that permitted the acquiring company to adjust the merger consideration); *Jackson v. Turnbull,* C.A. No. 13042 (Del. Ch. Feb. 8, 1994) (holding that a board cannot delegate setting merger consideration pursuant to Section 251(b)).

201 *Canal Capital Corp. v. French*, C.A. No. 11764 (Del. Ch. July 2, 1992), slip op. at 6.

202 *Canal Capital Corp. v. French*, C.A. No. 11764 (Del. Ch. July 2, 1992), slip op. at 6.

203 William Meade Fletcher, *Cyclopedia of the Law of Private Corporations* § 499 (perm. ed. rev. vol. 1990).

204 William Meade Fletcher, *Cyclopedia of the Law of Private Corporations* § 499 (perm. ed. rev. vol. 1990).

205 William Meade Fletcher, *Cyclopedia of the Law of Private Corporations* § 499 (perm. ed. rev. vol. 1990).

206 *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 943 (Del. 1985); *Kelly v. Bell*, 254 A.2d 62 (Del. Ch. 1969), *aff'd*, 266 A.2d 878 (Del. 1970); *see also* § 4.16[B].

207 *Grimes v. Donald*, C.A. No. 13358 (Del. Ch. Jan. 11, 1995), slip op. at 1, *aff'd*, 673 A.2d 1207 (Del. 1996).

208 *Grimes v. Donald*, C.A. No. 13358 (Del. Ch. Jan. 11, 1995), slip op. at 1-2, *aff'd*, 673 A.2d 1207 (Del. 1996).

209 *RBC Capital Mkts., LLC v. Jervis*, 129 A.3d 816, 855 (Del. 2015).

210 *Perlegos v. Atmel Corp.*, C.A. Nos. 2320-N & 2321-N (Del. Ch. Feb. 8, 2007), slip op. at 38 (quoting Treatise).

211 Section 141(c) provides that board committees may be constituted only by "resolution passed by a majority of the whole board."

212 *See Clarke Mem'l Coll. v. Monaghan Land Co.*, 257 A.2d 234, 241 (Del. Ch. 1969).

213 *Scattered Corp. v. Chi. Stock Exch., Inc.*, C.A. No. 14010 (Del. Ch. July 12, 1996), slip op. at 6 n.4 (citing Treatise).

214 *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981). See § 13.14 for further discussion of special litigation committees.

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215 *Cf. Freedman v. Rest. Assocs. Indus., Inc.*, C.A. No. 9212 (Del. Ch. Oct. 16, 1987), slip op. at 21 ("Heavy reliance is placed upon the acts of specially constituted committees of disinterested directors when Delaware courts are asked to review the propriety of corporate transactions that involve elements or claims of self-dealing. While that reliance may, given the informal relations that may exist between board members, be seen as providing a possible escape-hatch for the unprincipled, cases such as this demonstrate that this technique of negotiation, when pursued in good faith, is a close surrogate for the structure that ordinarily provides protection to shareholders." (citation omitted)).

216 8 *Del. C.* § 141(c)(2).

217 Committee on Corporate Laws, *The Overview Committees of the Board of Directors*, 35 Bus. Law. 1335 (1980).

218 *See* Brodsky & Adamski, *Law of Corporate Officers and Directors* § 8.04 (1984).

219 *See* Committee on Corporate Laws, *Corporate Director's Guidebook* 61, 70 (5th ed. 2007). The significance of the role of independent directors in sensitive business decisions is discussed or demonstrated in, among other cases, *Oberly v. Kirby*, 592 A.2d 445 (Del. 1991); *Mills Acquisition Co. v. Macmillan, Inc*., 559 A.2d 1261 (Del. 1989); *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983); *Getty Oil Co. v. Skelly Oil Co.*, 267 A.2d 883, 887 (Del. 1970); *In re RJR Nabisco S'holders Litig.*, C.A. No. 10389 (Del. Ch. Jan. 31, 1989), *appeal denied*, 556 A.2d 1070 (Del. 1989); *Robert M. Bass Group, Inc. v. Evans*, 552 A.2d 1227 (Del. Ch. 1988), *appeal dismissed*, 548 A.2d 498 (Del. 1988); *Freedman v. Rest. Assocs. Indus., Inc.*, C.A. No. 9212 (Del. Ch. Oct. 16, 1987); *In re Trans World Airlines, Inc. S'holders Litig.*, C.A. No. 9844 (Del. Ch. Oct. 21, 1988); *In re Maxxam Group, Inc. Stockholders Litig.*, C.A. No. 8636 (Del. Ch. Apr. 16, 1987), slip op. at 23-24; and *Reading Co. v. Trailer Train Co.*, C.A. No. 7422 (Del. Ch. Mar. 15, 1984), slip op. at 14-16; *see also* William T. Allen, *Independent Directors in MBO Transactions: Are They Fact or Fantasy?*, 45 Bus. Law. 2055 (1990); E. Norman Veasey, *Duty of Loyalty: The Criticality of the Counselor's Role*, 45 Bus. Law. 2065 (1990).

220 *See, e.g.*, 15 U.S.C. § 78j-1(m)(3)(A) (providing that "[e]ach member of the audit committee of the issuer shall be a member of the board of directors of the issuer, and shall otherwise be independent"); New York Stock Exchange Listed Company Manual § 303A.05(a) ("Listed companies must have a compensation committee composed entirely of independent directors.").

221 *See, e.g.*, *Weinberger v. UOP, Inc.*, 457 A.2d 701, 709 n.7 (Del. 1983); *Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110 (Del. 1994); *see also Cohan v. Loucks*, C.A. No. 12323 (Del. Ch. June 11, 1993).

222 8 *Del. C.* § 141(c)(1)-(2).

223 8 *Del. C.* § 141(c)(1)-(2).

224 *See Krasner v. Moffett*, 826 A.2d 277, 280 (Del. 2003).

225 Amendments to the certificate of incorporation are governed not only by the process set forth in Section 242, but also by the process whereby the board may, by certificate of designations, set forth the terms of certain stock if the board is so empowered pursuant to Section 151(g). A certificate of designations that has been duly adopted and filed becomes an amendment to the certificate of incorporation under Section 104. Thus, when the certificate of incorporation is restated pursuant to Section 245(a), amendments occasioned by certificates of designations must be restated in full. The 1983 Amendments to Section 141(c)(1)--formerly Section 141(c)--permit a committee to amend the certificate of incorporation by means of a certificate of designations (to the extent it is expressly authorized in the resolution) by permitting it to fix certain terms of the stock after the board has adopted a resolution pursuant to Section 151(a).

226 8 *Del. C.* § 141(c)(1).

227 8 *Del. C.* § 141(c)(2).

228 8 *Del. C.* § 141(c)(2); *see also In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 54 (Del. 2006) ("The Delaware General Corporation Law (DGCL) expressly empowers a board of directors to appoint committees and to delegate to them a broad range of responsibilities, which may include setting executive compensation. Nothing in the DGCL mandates that the entire board must make those decisions." (footnote omitted)).

229 See § 5.12 for further discussion of certificates of designations.

230 *See* 1983 Amendment to Section 141(c) *and* the commentary thereto.

231 *See* 1985 Amendment to Section 141(c) *and* the commentary thereto.

232 *See* § 5.1.

233 *See generally* Brodski & Adamski, *Law of Corporate Officers and Directors* § 8.07 (1984).

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234 *Hessler, Inc. v. Farrell*, 226 A.2d 708, 712 (Del. 1967); *Amaysing Techs. Corp. v. CyberAir Commc'ns, Inc.*, C.A. No. 19890-NC (Del. Ch. Mar. 3, 2005), slip op. at 12; *see also Guthridge v. Pen-Mod, Inc.*, 239 A.2d 709 (Del. Super. Ct. 1967).

235 8 *Del. C.* § 122(5).

236 *Stoms v. Fed. Serv. Ins. Co.*, 125 A.3d 1102, 1108 n.28 (Del. 2015) (quoting Treatise).

237 ***Grimes*** *v.* ***Donald***, 673 A.2d 1207, 1214 (Del. 1996).

238 8 *Del. C.* § 142(a)-(b); *see also Stoms v. Fed. Serv. Ins. Co.*, 125 A.3d 1102, 1108 n.28 (Del. 2015) (quoting Treatise).

239 8 *Del. C.* § 142(b); *Gorman v. Salamone*, C.A. No. 10183-VCN (Del. Ch. July 31, 2015), slip op. at 16 n.37 (quoting Treatise); *id.* at 9 (invalidating bylaw because "Delaware law does not allow stockholders to remove directly corporate officers through authority purportedly conferred by a bylaw").

240 *See* 1 Edward P. Welch et al., *Folk on the Delaware General Corporation Law* § 142.2 (5th ed. 2006).

241 8 *Del. C.* § 142(a); *see Espinoza v. Zuckerberg*, 124 A.3d 47, 56 n.41 (Del. Ch. 2015) ("To ensure accurate recordkeeping of actions taken at stockholder meetings, the DGCL specifically requires every Delaware corporation to have one officer with 'the duty to record the proceedings of the meetings of the stockholders and directors in a book to be kept for that purpose.' . . . Notably, this is the only duty of an officer that is specifically set forth in the statute.").

242 8 *Del. C.* § 141(a); *see also* § 4.1.

243 *Gantler v. Stephens*, 965 A.2d 695, 708-09 (Del. 2009); *City of Miami Gen. Emps' & Sanitation Emps' Ret. Trust v. Comstock*, C.A. No. 9980-CB (Del. Ch. Aug. 24, 2016), slip op. at 54 ("Under Delaware law, officers owe the same fiduciary duties as directors."), *aff'd*, 158 A.3d 885 (Del. 2017) (TABLE); *Dweck v. Nasser*, C.A. No. 1353-VCL (Del. Ch. Jan. 18, 2012), slip op. at 25; *In re Walt Disney Co. Derivative Litig.*, C.A. No. 15452 (Del. Ch. Sept. 10, 2004), slip op. at 8 ("To date, the fiduciary duties of officers have been assumed to be identical to those of directors."); *see also Ryan v. Gifford*, 935 A.2d 258, 269 (Del. Ch. 2007) (same); *McPadden v. Sidhu*, 964 A.2d 1262, 1275 (Del. Ch. 2008) (stating that "an officer owes to the corporation identical fiduciary duties of care and loyalty as owed by directors"); *In re Walt Disney Co. Derivative Litig*., 907 A.2d 693, 777 n.588 (Del. Ch. 2005) ("The parties essentially treat both officers and directors as comparable fiduciaries, that is, subject to the same fiduciary duties and standards of substantive review. Thus, for purposes of this case, theories of liability against corporate directors apply equally to corporate officers, making further distinctions unnecessary."); *Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939); John Mark Zeberkiewicz & Blake Rohrbacher, *The Fiduciary Duties of Officers Under Delaware Law*, Insights, June 2008, at 2; *Bridgeport Holdings Inc. Liquidating Trust v. Boyer*, 388 B.R. 548, 574 (Bankr. D. Del.) (stating that, "under Delaware law, [the oversight] theory of liability typically applies to directors, and not officers"); *Hampshire Group, Ltd. v. Kuttner*, C.A. No. 3607-VCS (Del. Ch. July 12, 2010), slip op. at 24 (applying the "gross negligence" standard to a claim against officers for breach of their duty of care); *id.* at 25 (noting that the "court must examine the officers' state of mind to determine whether they acted in bad faith for a purpose other than advancing the best interests of the corporation"); *id.* at 71 (holding that "no officer or employee has the right to make a corporation a law breaker"); *id.* at 75, 80-81 (finding breaches of officers' duty of loyalty); *Dweck v. Nasser*, C.A. No. 1353-VCL (Del. Ch. Jan. 18, 2012), slip op. at 38-39 (holding that an officer """can be held liable for a breach of the duty of loyalty only if he consciously facilitated wrongful action by another for a purpose other than advancing the best interests of the corporation" and finding that he breached his duty by acting in bad faith: "Fine facilitated Dweck's wrongful conduct by consciously abdicating his duty to review her expenses. Reviewing and approving expenditures was part of his job, yet he knowingly chose not to do it.").

244 *Science Accessories Corp. v. Summagraphics Corp.*, 425 A.2d 957 (Del. 1980); *Beard Research, Inc. v. Kates*, 8 A.3d 573, 601 (Del. Ch. 2010), *aff'd sub nom. ASDI, Inc. v. Beard Research, Inc.*, 11 A.3d 749 (Del. 2010); *see also Brophy v. Cities Serv. Co.*, 70 A.2d 5 (Del. Ch. 1949).

245 *In re Oracle Corp. Derivative Litig.*, 867 A.2d 904 (Del. Ch. 2004), *aff'd*, 872 A.2d 960 (Del. 2005); *Brophy v. Cities Serv. Co.*, 70 A.2d 5 (Del. Ch. 1949); *Hampshire Group, Ltd. v. Kuttner*, C.A. No. 3607-VCS (Del. Ch. July 12, 2010), slip op. at 27 (noting that officers have a duty to disclose certain material information to their superiors).

246 *See, e.g.*, *City of Miami Gen. Emps' & Sanitation Emps' Ret. Trust v. Comstock*, C.A. No. 9980-CB (Del. Ch. Aug. 24, 2016), slip op. at 54-55 (dismissing claims against officers because the business judgment presumption applied), *aff'd*, 158 A.3d 885 (Del. 2017) (TABLE); *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) (noting that "the business judgment rule attaches to protect corporate officers and directors and the decisions they make"), *modified*, 636 A.2d 956 (Del. 1994); *Kelly v. Bell*, 266 A.2d 878, 879 (Del. 1970) ("[E]ven if they did in

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fact violate some such public policy, the directors or officers were not necessarily liable to the corporation because they honored the commitment, provided they exercised honest business judgment in doing so."); *Haber v. Bell*, 465 A.2d 353, 357 (Del. Ch. 1983) ("The business judgment rule, which is a presumption that a rational business decision of an officer or director is proper unless facts exist which remove the decision from the protection of the rule, is a potential defense to allegations of Board interestedness and demand futility."); *Pogostin v. Rice*, C.A. No. 6235 (Del. Ch. Aug. 12, 1983), slip op. at 7 (same); *Kaplan v. Centex Corp.*, 284 A.2d 119, 124 (Del. Ch. 1971). If a defendant is both an officer and a director, Section 102(b)(7) does not limit liability for the defendant's actions taken solely as an officer. *Arnold v. Soc'y for Sav. Bancorp, Inc.*, 650 A.2d 1270, 1288 (Del. 1994) (citing Treatise).

247 *Compare* Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 Bus. Law. 439 (2005) (arguing generally that the business judgment rule does not apply to officers), *with* Lawrence A. Hamermesh & A. Gilchrist Sparks, III, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 Bus. Law. 865 (2005) (arguing the opposite).

DELCBO § 4.10

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2009 WL 1541942 (Del.Supr.) (Appellate Brief)
Supreme Court of Delaware.

NORFOLK COUNTY RETIREMENT SYSTEM, Plaintiff Below, Appellant,
v.
JOS. A. BANK CLOTHIERS, INC., Defendant Below, Appellee.

No. 118, 2009.
May 20, 2009.

Court Below - Court of Chancery of the State of Delaware, Civil Action No. 3443

Answering Brief of Appellee Jos. A. Bank Clothiers, Inc.

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*1 *NATURE OF PROCEEDINGS*

The central issue in this appeal is whether the Court of Chancery correctly concluded that a stockholder in a Section 220 case must make a showing why it is entitled to more than the report of a Special Litigation Committee ("SLC") and related documents when the SLC has already investigated the matter that the stockholder seeks to investigate.

This case had its origin on June 7, 2006, when Jos. A. Bank Clothiers, Inc. ("JAB" or "the Company") announced that its first-quarter 2006 earnings were six cents per share lower than its first-quarter 2005 earnings. On August 11, 2006, Glen Hutton filed a shareholders' derivative suit in the United States District Court for the District of Maryland against the Company's directors, alleging breaches of fiduciary duty in connection with that one-quarter diminution in earnings. Hutton alleged that demand on the Company's Board would be futile because the Company's directors lacked independence.

In an opinion dated September 13, 2007, the Maryland District Court dismissed the *Hutton* Action, holding that demand was not excused. Four days later, on September 17, 2007, Hutton demanded that the Company investigate the allegations made in the *Hutton* Action. The Company formed an SLC composed of non-management directors to investigate Hutton's demand.

On November 27, 2007, while the SLC was conducting its investigation, Norfolk County Retirement System served a Section 220 demand seeking a broad range of documents relating to ***2** the Company's internal controls, accounting practices and other matters. Norfolk's stated purposes for the inspection related to the possible filing of a derivative suit relating to the Company's June 7, 2006 earnings announcement.

The Company informed Norfolk's counsel of the ongoing SLC investigation and asked Norfolk to wait for the SLC's report before taking further steps under Section 220. Norfolk did not do so. Instead, Norfolk filed this action on January 3, 2008.

The SLC issued its Report on February 7, 2008. The Report comprehensively refuted the allegations of wrongdoing identified by Hutton, which were also the subject of a pending federal securities law case. While this case was pending, the Company provided Norfolk with the SLC Report, its exhibits and the corporate minutes relating to the SLC.

On September 10, 2008, the parties cross-moved for summary judgment. The cross-motions were presented for decision based on the record submitted with the motions, pursuant to Court of Chancery Rule 56(h). By a Memorandum Opinion dated February 12, 2009, the Court of Chancery denied Norfolk's summary judgment motion, granted the Company's motion, and dismissed the Complaint with prejudice. [1] This appeal followed.

*3 *SUMMARY OF ARGUMENT*

1. Denied. The Court of Chancery correctly decided the collateral estoppel issue, because Norfolk failed to identify any respect in which the plaintiff in the *Hutton* Action failed to represent the Company adequately. Accordingly, Norfolk would be collaterally estopped from claiming in a future derivative suit that demand would be excused. Further, the issue of whether Hutton adequately represented the Company is an independent, secondary basis for the Court of Chancery's decision.

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2. Denied. The Company provided to Norfolk documents that comprehensively addressed Norfolk's stated purpose of investigating a possible derivative suit in connection with the Company's June 2006 earnings announcement. These documents included the SLC Report, its exhibits, and the corporate minutes relating to the SLC. Norfolk did not carry its burden of showing why it was entitled to additional categories of documents, or why the documents it received were not adequate to satisfy its stated purposes. Norfolk failed to identify any basis to question the independence, good faith and thoroughness of the SLC's investigation. Norfolk also failed to identify any evidence or legal basis on which the derivative suit it seeks to file might conceivably overcome the SLC's determination that the Company should not pursue such litigation.

*4 *COUNTER-STATEMENT OF FACTS*

A. *The Securities Class Action*

On June 7, 2006, the Company announced that in the first quarter of its 2006 fiscal year, it earned about six cents per share less than it had in the first quarter of 2005. [2] (A105, ¶20) The next day, the Company's stock price dropped substantially. (A105, ¶22)

In reaction, on July 24, and August 3, 2006, two securities class action lawsuits were filed in the U.S. District Court for the District of Maryland and consolidated before Judge William N. Nickerson. (The consolidated cases are collectively referred to herein as the "Securities Class Action"). (A187-A283)

The present complaint in the Securities Class Action alleges that senior management caused the Company to purchase excessive inventory for the Fall/Winter 2005-06 season, and after sales of that merchandise were supposedly disappointing, the Company attempted to liquidate the allegedly excessive inventory by unprecedented sales and promotional activity in the first quarter of 2006. (A191-A193, ¶¶ 5-9) The result, according to the Securities Class Action complaint, was a diminution in gross profit margin and earnings. (A193, ¶ 10)

The complaint alleges that the Company and its senior management issued false and misleading statements concerning the ***5** Company's financial affairs. (A221, ¶ 85; A228-A232, ¶¶ 102-105) Those statements were false, the complaint alleges, because they omitted the Company's knowledge of allegedly excessive levels of inventory and discounting from December 2005 through June 2006. (A221, ¶ 85; A233-A234, ¶ 108)

The Securities Class Action complaint makes numerous anecdotal assertions in support of the foregoing allegations, including:

• That the Company's distribution centers were so overloaded that the Company was required to store excessive inventory in trailers in the parking lot. (A210, ¶ 59)

• That a Company vice president, Robert Hensley, acknowledged during a presentation in January 2006 that the Company had excessive inventory. (A212, ¶ 63)

• That the Company ran more sales and promotional events in the first quarter of 2006 than it had in the first quarter of 2005. (A212-A213, ¶ 65)

• That "addendums" marked "urgent" were sent to stores by facsimile to implement price reductions. (A213-A214, ¶¶ 67-68)

• That the Company implemented a company-wide "Code Red" in April 2006 in order to liquidate excess inventory. (A216, ¶ 75)

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The Securities Class Action complaint also alleges that the Company's inventory was "impaired" (that is, worth less than it cost) as an accounting matter, and was overvalued on the Company's financial statements, with the result that those statements did not comply with GAAP. (A221, ¶ 85)

The Securities Class Action complaint has survived the Company's motion to dismiss and motion for judgment on the ***6** pleadings, but the trial judge has acknowledged that it is a "close case" as to whether it states a claim at all. (A648)

B. *The Hutton Action*

On August 11, 2006, Glen Hutton filed a shareholder derivative action in the U.S. District Court for the District of Maryland alleging that the members of the Company's Board of Directors had breached their fiduciary duties to the Company in connection with the same conduct alleged in the Securities Class Action. (A471-A496) A second derivative action was filed on August 28, 2006 (B251-B283), and the actions were consolidated before Chief Judge Legg on October 20, 2006 ("the *Hutton* Action"). (A471-A496) The plaintiff in the *Hutton* Action did not make a demand on the Board before filing his lawsuit, claiming that demand would be futile because the Company's directors were not independent. (A485-A486, ¶ 39)

On September 13, 2007, Chief Judge Legg dismissed the complaint in the *Hutton* Action, because it did not include any "particularized allegations creating a reasonable doubt that a majority of the Directors would be disinterested or independent in considering a shareholder demand," and, therefore, demand was not excused. (A315-A316)

Hutton did not appeal. Instead, through his attorneys, he sent a letter to the Company's Board, demanding that it establish an SLC "to take action to fully investigate and remedy, *inter alia*, potential breaches of fiduciary duty by certain current ***7** and/or former officers and directors of the Company...." (B298-B300)

C. *The Establishment of the SLC*

On September 25, 2007, the Company's Board appointed the SLC and gave it full authority to investigate the claims alleged by Hutton and take all appropriate action with respect to those claims. (A497-A498) The members of the SLC -- Directors William E. Herron, Sidney H. Ritman, and Andrew A. Giordano -- are not members of the Company's management. (A417; A422-A423) They are among the Board members that Judge Legg, based on the *Hutton* complaint, considered to be capable of considering a derivative demand. (A417) The SLC retained the law firm of Kramon & Graham, P.A. ("K&G") to represent its interests. (A499-A500) Hutton's counsel informed the SLC that all of the allegations that her client believed should be investigated by the SLC were included in the Securities Class Action complaint, and the SLC focused its investigation on those allegations. (A427-A428; A506)

D. *The Section 220 Demand and Complaint*

On November 27, 2007, more than seventeen months after the earnings announcement that gave rise to the Securities Class Action and the *Hutton* Action, and after the SLC's investigation was well under way, Norfolk served a demand for inspection pursuant to Section 220. (A108-A114) Norfolk's stated purposes for the inspection were virtually identical to the subject matter of the *Hutton* Action, the Securities Class Action, and the SLC investigation:

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***8** A. To investigate potential wrongdoing, mismanagement, and breaches of fiduciary duties by the members of the Company's Board of Directors or others in connection with the events, circumstances, and transactions underlying the Company's June 2006 Form 10-Q, including, among other things, the events surrounding the Company's announcements that Jos. A. Bank's gross profits had declined (by 16% as compared with the prior year period) as a result of increased consumer demand for fall merchandise, resulting in less demand for year-round core merchandise;

B. To assess the ability of the Company's Board of Directors to impartially consider a demand for action (including a request for permission to file a derivative lawsuit on the Company's behalf) related to the items described in this demand; and

C. To take appropriate action in the event the members of the Company's Board of Directors did not properly discharge their fiduciary duties.

(A110)

Norfolk sought a broad range of documents that would have allowed it to conduct a comprehensive review of the Company's entire control structure, accounting processes, audit processes and pricing strategies. (A108-A109, ¶¶ 1-11)

On December 19, 2007, the Company, through counsel, informed Norfolk's counsel of Hutton's derivative demand and the ongoing SLC investigation. (A116-A117; 118-A119) The Company asked Norfolk to hold its Section 220 demand in abeyance until the SLC completed its investigation and issued its report, which was anticipated to occur around the end of January 2008. (A116-A117) Instead, Norfolk filed its complaint in this case on January 3, 2008. (A99-A107) Norfolk has never explained why it ***9** could not wait one additional month (after the seventeen months during which it had already sat on its hands) to review the SLC Report before filing this action.

E. *The Proceedings Below*

(1) *The Company's Provision of Documents to Norfolk*

After the SLC completed its investigation and issued its Report, on February 7, 2008, the Company gave a copy of the SLC Report to Norfolk. (Op. at *12) The Company later provided Norfolk with the exhibits to the SLC Report and corporate minutes relating to the SLC (including the minutes of the SLC itself). (*Id.*)

The SLC Report identified and addressed the claims of wrongdoing made in the Securities Class Action and the *Hutton* demand. (A409-A470) The Report indicates that the SLC interviewed over forty current and former Company employees and outside professionals (A418; B554), and held eleven meetings to review the investigation's progress. (A418) It also reviewed numerous documents, including approximately 5,000 emails, several of the Company's securities filings, the CEO's stock trading plan, the forms filed by the Company's CEO with the Securities and Exchange Commission reflecting the CEO's sales of stock, and numerous internal Company documents, including store expansion schedules and progress reports, audit letters, management letters, spreadsheets, financial projections, marketing event calendars, and organizational charts. (A428-A429) The SLC interviewed all members of the Company's senior management, ***10** current and former employees with knowledge of inventory and sales issues, store managers, Company planners, and many of the persons identified by the Securities Class Action plaintiffs as having knowledge of facts relating to the claims in that action. (A429; B554)

Among other things, the SLC concluded that:
• The Company's inventory was never impaired.

• No one at the Company who was in a position to know whether the inventory was excessive thought that it was; and, in fact, the inventory was not excessive.

• The sales and promotions used by the Company to motivate customers to buy were not drastic or different in nature or frequency from sales and promotions used by the Company in prior or subsequent years.

• The Company's management did not lie to the public or improperly withhold information from it. Earnings in the first quarter of 2006 were affected adversely by unexpected expenses and the customers' preferences for discounted Fall/Winter merchandise, but management correctly believed that the dip in earnings would be temporary. In fact, 2006 turned out to be a record year for the Company in all respects, notwithstanding the first quarter results. The Company's internal documents matched its public disclosures, and the SLC found no evidence that any member of the Company's management had engaged in any fraudulent behavior.

(A414-A415)

The Report's exhibits included numerous internal company documents relevant to the specific allegations of wrongdoing. (B67-B69) For example:

• In response to the allegations that the Company's financial statements overstated the value of its inventory and ***11** therefore its financial statements did not comply with GAAP, the Company produced a substantial quantity of information, including:

(1) Internal Company accounting documents showing the Company's actual (minuscule) sales below cost for fiscal years 2005 and 2006. (B811; B12)

(2) Internal documentation of the Company's analysis of its inventory in connection with the establishment of its inventory reserves. (B817-B819; B821-B823)

(3) An evaluation of the Company's inventory conducted by an independent firm on behalf of the Company's lender, dated February 3, 2006. (B825-B974)

(4) The Company's auditors' unqualified opinions on its financial statements, which were included in its annual securities filings. (B355-B356; B468-B469)

(5) Documents reflecting an internal investigation conducted by the Wilmer Hale law firm and the Ernst & Young accounting firm into an earlier allegation that the Company had not properly accounted for its inventory. That investigation arose from an anonymous complaint the Company received in March 2006, squarely in the middle of the relevant period. The investigation concluded that the Company's inventory accounting was proper and complied with GAAP. (B976-B979; B981-B985) [3]

***12** • In response to the allegation that the Company had bought too much inventory for the Fall/Winter 2005-2006 season and was left with a “glut” at the end of the season, the Company provided its “open to buy” report for the relevant period, which reflected its actual and planned inventory levels. (B668-B669) The Company provided documentation relating to its alleged use of storage trailers to house excess inventory

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-- which established that there had been no storage trailers during the relevant period. (B671-B708) The Company produced an actual DVD copy of the presentation in which Mr. Hensley had allegedly made admissions about the Company's having too much inventory -- admissions that were utterly absent from the presentation. (The DVD presentation was attached to the SLC Report as Exhibit 22, B712)

• In response to the allegation that the Company had engaged in unprecedented promotional events and sales during the first quarter of 2006, the Company provided, among other things, the Company's actual marketing calendars for the relevant time period, which established that the Company's sales events in the first quarter of 2006 were no more frequent than its sales events in the first quarter of 2005 (B714-B717); copies of the Company's actual "addendums" sent to stores, which did not support the allegations made in the Complaint (B719-B807); and the actual documents relating to the alleged "Code Red," which demonstrated that the "Code Red" situation had nothing to do with excessive inventory. (B809) Rather, it was simply a phrase used in the ***13** course of an e-mail by a single Divisional Vice President who was frustrated by his division's relatively subpar sales on a particular day in comparison to strong sales increases in other areas of the Company.

The SLC Report exhibits also included internal Company e-mails documenting its actual contemporaneous expectations as to its gross profit margins during the first quarter of 2006 (B987; B989-B990; B992), and documents relating to sales of stock by the Company's then-CEO, Robert N. Wildrick. (B1109-B1115)

To date, Norfolk has not identified why these documents are not sufficient to satisfy its articulated purposes for the document inspection. Norfolk simply referred below to the unproven allegations contained in the Securities Class Action -- but, as the Court of Chancery observed, Norfolk never identified any respect in which the SLC Report and exhibits did not appropriately address those allegations. (Op. at *36 n. 88)

Additionally, Norfolk has failed to state why it believes it is entitled to the broad categories of additional documents that it seeks. Norfolk has never stated any reason why it is entitled to an examination of documents relating to *all* the Company's internal controls, when the only allegations relating to internal controls relate to the Company's accounting for inventory, which is comprehensively addressed in the documents that the Company provided to Norfolk. Norfolk has never explained why it needs a full set of documents relating to the audits of the Company, when the only audit-related wrongdoing ***14** alleged relates to the Company's accounting for inventory - and the Company did provide substantial information on that topic. Norfolk has never explained why it needs every document relating to GAAP compliance, when the only instance of alleged GAAP non-compliance even mentioned in the Securities Class Action relates to inventory valuation, a topic addressed in depth in documents provided by the Company.

(2) ***Norfolk's Statements as to the Purpose of Its Inspection Demand***

In the proceedings below, Norfolk repeatedly acknowledged that it sought to inspect the Company's records for the purpose of evaluating and pursuing a derivative action, based on the same alleged wrongdoing that had been found by the SLC to be without substance. Norfolk's counsel stated in a hearing before the Court of Chancery that filing a derivative suit is the purpose of Norfolk's investigation: "We are trying to seek books and records to support -- if in fact it's supportable -- demand futility in the derivative context where there is an SLC report." (A358) In its summary judgment motion Norfolk stated that it "filed this action in order to investigate potential corporate mismanagement and to determine whether there is a basis to file a shareholder derivative action." (A49-A50, ¶ 8)

Norfolk has not articulated any other purpose for its inspection demand. Even in its brief before this Court, Norfolk asserts that it "has not committed itself to bring a future derivative action," but it has failed to articulate any other purpose for its inspection. (Norfolk Op. Br. at 19)

15 (3)** ***Norfolk's Admission That It Had No Basis For Challenging The SLC's Independence, Thoroughness Or Good Faith

As the Court of Chancery found, Norfolk made no meaningful attempt to question the independence of the SLC, the adequacy of its process or the reasonableness of its investigation and conclusions. (Op. at *30)

On the contrary, when Norfolk's corporate designee Joseph Connelly, was deposed, he candidly testified that Norfolk had no reason to believe that the SLC could not pursue its investigation in good faith or that the SLC members were not independent:
Q: Are you aware of any facts today that would lead you to believe that the company's board is not capable of conducting an independent, thorough, good faith investigation of allegations relating to its earnings announcement in first quarter of 2006?

A: No.

(B1173 at 39:11-16; Op at *30-31 n. 70)

F. ***The Court of Chancery's Decision***

The Court of Chancery issued its decision on February 12, 2009. It held that Norfolk had demonstrated no right under Section 220 to inspect any documents in addition to those provided by the Company in the course of the litigation. (Op. at *52-53) Accordingly, it granted defendant's motion for summary judgment and denied plaintiff's motion for summary judgment. (*Id.* at *53)

The Court's decision had three principal bases:

***16** *First*, the Court explained that Norfolk had received documents sufficient to evaluate its proposed derivative suit, and had not shown why it was entitled to additional documents:

> Norfolk received a number of documents that should suffice for the purpose of evaluating a derivative suit. Like the situation in [*Kaufman v. CA, Inc.*, 905 A.2d 749 (Del. Ch. 2006)], Norfolk must now articulate a reasonable need for whatever additional documents it seeks. Norfolk could have studied the documents provided by the Company to show how those documents are insufficient or how other documents are necessary. Yet, Norfolk failed to do so. *In particular, Norfolk has not proffered any evidence to demonstrate reasonable grounds for suspicion about the SLC's independence, good faith, or due care, or the reasonableness of its process or conclusions*. Thus, I can conclude the Company has produced all of the documents required under § 220, the relevant case law, and the circumstances of this case as to Norfolk's purpose of exploring a possible derivative suit.

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(Op. at *35-36) (emphasis added). The Court went on to state:

> Norfolk argues that it cannot demonstrate that the SLC Report was inadequate, because to do so, it would need additional documents or discovery. I disagree, especially in light of the low burden of proof required for a Section 220 claim. Norfolk could have compared, for example, the complaint in the Securities Class Action to the SLC Report and attempted to demonstrate that the SLC did not adequately address issues raised by the complaint in that action. Once it was provided with the SLC Report and the exhibits thereto, Norfolk also could have identified weaknesses in the SLC's investigation or its Report that might provide a credible basis to distrust the way in which the SLC proceeded or the conclusions the SLC reached.

(Op. at *36, n. 88)

Second, the Court acknowledged that Norfolk's stated purpose of investigating the possibility of bringing a derivative action could be proper, but that if such a derivative action would be barred by claim or issue preclusion, then a Section 220 demand could be denied. (Op. at *20) The Court disagreed with ***17** Norfolk's contention that it could not be collaterally estopped by the decision in the *Hutton* Action from asserting in a future action that demand should be excused. The Court stated that the "applicability of collateral estoppel depends upon the adequacy of representation in the prior proceeding," and rejected Norfolk's claims that it had not been adequately represented by the SLC or by Hutton. (Op. at *28-30)

Third, the Court analyzed whether Norfolk had any other purpose for seeking documents other than filing a derivative suit. (Op. at *36-41) It observed that Norfolk had not identified any other purpose for its proposed inspection, but gave Norfolk the benefit of the doubt on this issue. (Op. at *40-41) Even so, the Court recognized that in light of the existence of the SLC Report, the reliability and reasonableness of which had been unchallenged, the bare existence of the undismissed Securities Class Action was not sufficient to carry Norfolk's burden of proof to obtain additional documents. (Op. at *52-53)

18** ***ARGUMENT

I. ***The Court Of Chancery Did Not Abuse Its Discretion Or Commit An Error Of Law When It Ruled That The Company's Production Of The SLC Report, Its Exhibits, And The Corporate Minutes Relating To The SLC Was Sufficient.***

A. ***Question Presented***

Did the Court of Chancery abuse its discretion or commit an error of law when it ruled that the Company's production of the SLC Report, its exhibits, and the corporate minutes relating to the SLC satisfied the Company's obligations under Section 220, where the stated purpose for the Section 220 demand was to investigate a potential derivative suit based on allegations that had already been investigated by the SLC, and Norfolk did not identify any basis for to challenging the independence, good faith, or thoroughness of the SLC or its conduct of the investigation? (Op. at *13-14; A331-A336)

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B. ***Scope of Review***

"Absent any apparent error of law, this Court reviews for abuse of discretion the decision of the trial court regarding the scope of a stockholder's inspection of books and records." *Security First Corp. v. U.S. Die Casting and Dev. Co.*, 687 A.2d 563, 569 (Del. 1997). *See also McKesson Corp. v. Saito*, 818 A.2d 970, 2003 Del. LEXIS 121, *1 (Del. Mar. 7, 2003) (Order) "To the extent that the Court of Chancery exercised its discretion in defining the scope of discovery in an on-going Section 220 proceeding in that court, we review that ruling under an abuse of ***19** discretion standard."). This standard of review is based on the statutory provision vesting the Court of Chancery with the power "in its discretion, [to] prescribe any limitations or conditions with reference to the inspection[.]" 8 *Del. C.* § 220(c). If a finding that a plaintiff has not met its burden of proof with respect to certain books and records is supported by the record and is the product of an orderly and logical deductive process, the "concomitant decision to limit inspection will not be disturbed on appeal." *Thomas & Betts Corp. v. Leviton Mfg. Co.*, 681 A.2d 1026, 1034 (Del. 1996). Here, as discussed below, the Court of Chancery reviewed the record submitted by the parties pursuant to Court of Chancery Rule 56(h), including the deposition testimony of the corporate representative of Norfolk, and the absence of any argument or evidence attacking the substance of the SLC report, and determined, in its discretion, that Norfolk had not established an entitlement to any additional documents. Contrary to the standard set forth on page 10 of Norfolk's Opening Brief, when a case is decided pursuant to Court of Chancery Rule 56(h), "the usual standard of drawing inferences in favor of the nonmoving party does not apply." *American Legacy Foundation v. Lorillard Tobacco Co.*, 886 A.2d 1, 18 (Del. Ch. 2005), *aff'd*, 903 A.2d 728 (Del. 2006).

20 C.** ***Merits of Argument

1. ***The Court Properly Held That The Company Provided The Records To Which Norfolk Was Entitled***

Under Section 220, a stockholder has a statutory right to inspect books and records of the corporation if he or she can establish "proper purpose" for the inspection. The statute defines a "proper purpose" as any purpose "reasonably related to such person's interest as a stockholder." 8 *Del. C.* § 220(b). The stockholder bears the burden of proving a proper purpose. 8 *Del. C.* § 220(c). If the stockholder seeks to inspect documents relating to possible corporate wrongdoing, it must present "some evidence to suggest a credible basis from which a court can infer that mismanagement, waste or wrongdoing may have occurred." *Seinfeld v. Verizon Commc'ns, Inc.*, 909 A.2d 117, 118 (Del. 2006) (internal quotations omitted).

A stockholder inspection will only be compelled if, and to the extent that, stockholder wealth is enhanced by compelling an inspection in such circumstances:

> Investigations of meritorious allegations of possible mismanagement, waste or wrongdoing, benefit the corporation, but investigations that are indiscriminate fishing expeditions do not. At some point, the costs of generating more information falls short of the benefits of having more information. At that point, compelling production of information would be wealth-reducing, and so shareholders would not want it produced.

Id. at 122-23 (internal quotations and footnotes omitted).

Furthermore, "the plaintiff bears the burden of proving that each category of books and records is essential to the ***21** accomplishment of the stockholder's articulated purpose for the inspection." *Security First*

Corp., 687 A.2d at 569. This showing requires "specific and discrete identification, with rifled precision ... [to] establish that each category of books and records is essential to the accomplishment of the articulated purpose." *Saito v. McKesson HBOC, Inc.*, 806 A.2d 113, 117 (Del. 2002) (quoting *Brehm v. Eisner*, 746 A.2d 244, 266-67 (Del. 2000)).

In accordance with this doctrine, "[i]t is not enough for a Section 220 claim, however, merely to satisfy the proper purpose and credible evidence prongs of the test." *Polygon Global Opportunities Master Fund v. West Corp*., 2006 Del. Ch. LEXIS 179, *9 (Oct. 12, 2006). If a stockholder already possesses "all necessary, essential, and sufficient" information for its proper purpose, no inspection will be compelled. *Id.*

In this case, the only purpose clearly articulated by Norfolk was its desire to investigate a possible derivative suit against the Company's directors arising out of the announcement of the diminution in the Company's earnings in June 2006. (A358; A49-A50) This is the very same subject matter that the SLC has already investigated in depth. The Company has produced to Norfolk the complete results of that investigation, including numerous internal company documents that are directly relevant to the allegations of wrongdoing. (Op. at *12)

Even now, after more than a year of litigation in the Court of Chancery and the filing of a brief in this Court, Norfolk has ***22** not articulated why it needs *additional* documents to satisfy its purpose of investigating a potential derivative suit based on the events that the SLC has already investigated. (Op. at *35-36) Nor has it come forward with *any* evidence, much less a "credible basis," to challenge the independence and good faith of the SLC or the reasonableness of its investigation, or any basis to believe that a future derivative action could survive a motion to dismiss. (Op. at *35; 36 n. 88) In short, Norfolk has failed completely to carry its burden of showing that it is entitled to any documents in addition to those it has already received. [4] (Op. at *52-53)

Under the circumstances, any further production of documents would be "wealth reducing" and wasteful, and thus would not be authorized under Section 220. Accordingly, the Court of Chancery acted properly in ruling that Norfolk was not entitled to more documents than those it received.

In reaching its decision, the Court of Chancery applied principles developed in similar cases, including *Kaufman v. CA, Inc.*, 905 A.2d 749 (Del. Ch. 2006), ***Grimes*** *v.* ***Donald***, 673 A.2d 1207 (Del. 1996) ("***Grimes*** *I*"), *overruled on other grounds*, *Brehm* ***23** *v. Eisner*, 746 A.2d 244 (Del. 2000), and ***Grimes*** *v. DSC Commc'ns Corp.*, 724 A.2d 561 (Del. Ch. 1998) ("***Grimes*** *II*").

In ***Grimes*** *I*, this Court held that a stockholder who makes a derivative demand that is refused is entitled to file a Section 220 action "to obtain the relevant corporate records, such as reports or minutes, reflecting the corporate action and related information in order to determine whether or not there is a basis to assert that demand was wrongfully refused." ***Grimes*** *I*, 673 A.2d at 1218.

In its subsequent opinion in ***Grimes*** *II*, the Court of Chancery held that to make that determination, the plaintiff was "entitled to receive copies of the Special Committee's report, minutes of the meetings of the Special Committee and minutes of any meeting of the board of directors relating to the creation or functioning of the Special Committee, including any meeting of the board of directors at which the recommendation of the Special Committee was considered or approved." ***Grimes*** *II*, 724 A.2d at 567. The Court reasoned that "these basic documents should suffice for purposes of establishing or raising reasonable grounds for suspicions about a special committee's independence, good faith and due care." *Id.* The Court continued, "Thus, I conclude that the plaintiff is not entitled to receive or examine copies of other documents

not directly relating to the Special Committee's conclusions and recommendations unless he can ***24** articulate a reasonable need to inquire further after review of those basic documents." *Id.* [5]

The demand-refused context in which the Court of Chancery decided ***Grimes*** *II* is closely analogous to the situation here. In both cases, a special litigation committee had investigated the underlying allegations. In both, the essential inquiry is whether the special litigation committee, acting in the place of the board of directors on behalf of the corporation, properly discharged its responsibilities. In any situation where a special litigation committee has issued a report supporting a determination not to pursue derivative litigation, a stockholder is not allowed to proceed with a derivative action as if the special litigation committee and its report did not exist. Nor is the stockholder entitled to conduct its own investigation of all conceivable underlying documents in the corporation's possession. Rather, as the Court of Chancery held in ***Grimes*** *II*, the stockholder is confined to examination of the special litigation committee's report and related documents. *Id.*

***25** The Court of Chancery's similar decision in *Kaufman* arose in a Section 220 action that involved a special litigation committee's investigation of apparent wrongdoing that had already resulted in three former senior executives pleading guilty to criminal charges. 905 A.2d 749, 751. The corporation produced several categories of documents in response to the Section 220 demand. *Id.* The stockholder sought additional documents, such as interview summaries and memoranda created in connection with a prior Audit Committee investigation. *Id.* at 752.

The *Kaufman* Court decided the question based on "the same principles" articulated in ***Grimes*** *II*. *Id.* at 754. The Court held that "[w]hen a books and records action is brought with the goal of evaluating a possible derivative suit, the books and records that satisfy the action are those that are required to prepare a well-pleaded complaint." 905 A.2d at 753. The Court reasoned that the additional documents sought fell "well outside the traditional reach of Section 220 as articulated in ***Grimes***," and that the corporation had already provided the stockholder with "a wide range of basic documents that should provide her with a substantial basis to investigate potential misconduct at CA." *Id.* at 754. It went on to state that a "plaintiff is not entitled to receive or examine copies of documents not directly relevant to the Special Committee's conclusions and recommendations unless he can articulate a need to inquire further after review of those basic documents." 905 A.2d at 754 (*quoting* ***Grimes*** *II*). The Court noted that the plaintiff could ***26** not explain why the remaining documents were "either necessary or essential to her proper investigative purpose." *Id.* at 755.

The principles established in ***Grimes*** *II* and *Kaufman* dispose of Norfolk's claim that it is entitled to additional documents to explore its proposed derivative suit. The same "basic documents" identified in ***Grimes*** *II* and *Kaufman* have been provided to Norfolk. Norfolk has articulated no reasonable need to inquire further. (Op. at *35-36) Norfolk has never tried to explain why the "basic documents" provided by the Company are not sufficient for Norfolk's purposes, or why any need exists for production of any particular category of additional documents. (*Id.*)

Instead, Norfolk has operated under the false premise that it can pursue a wasteful, wealth-reducing investigation of alleged wrongdoing without regard for the facts that the SLC already conducted such an investigation, and that its Report was given to Norfolk - even though Norfolk's corporate representative freely admitted that he was not aware of any facts casting doubt on the SLC's ability to conduct an independent, good faith and thorough investigation (Op. at *30-31 n.70), and even though, as the Court of Chancery found, "Norfolk has not proffered any evidence to demonstrate reasonable grounds for suspicion about the SLC's independence, good faith, or due care, or the reasonableness of its processes or conclusions." (*Id.* at 35) Norfolk's false premise is inconsistent with the principles laid ***27** down in ***Grimes*** *II* and *Kaufman*, and the Court of Chancery properly rejected it. [6]

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2. ***Norfolk Failed To Challenge The SLC's Independence Below And Accordingly Cannot Do So For The First Time In This Court***

Norfolk claims for the first time on appeal that "the composition of the SLC raised questions as to its independence," because two members of the SLC served on the Company's Audit Committee, and *Hutton's* demand letter asked for an investigation of claims potentially relating to members of the Audit Committee. (Norfolk Op. Br. at 31) This Court should reject Norfolk's new argument.

First, Norfolk never raised it below, and therefore it should not be considered by this Court. *See* Supr. Ct. R. 8; *Karn v. Doyle*, 406 A.2d 36 (Del. 1979) (arguments not submitted to Vice Chancellor will not be considered by Supreme Court on appeal). Norfolk has not identified any basis upon which the "interests of justice" would require this Court to address this issue despite its failure to raise it below. *See* Supr. Ct. R. 8.

Second, even if the issue had been presented below, it would have had no merit. It is well established that a director's independence for the purpose of evaluating a derivative suit demand is not impaired simply by the fact that a ***28** derivative suit attempts to state a claim against that director. If it did, a plaintiff could circumvent the demand requirement entirely simply by making claims against all directors. *See Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993) ("the mere threat of personal liability for approving a questioned transaction, standing alone, is insufficient to challenge either the independence or disinterestedness of directors. . . ."); *Aronson v. Lewis*, 473 A.2d 805, 818 (Del. 1984) (rejecting a "bootstrap" argument that directors cannot impartially consider a derivative demand because they cannot be expected to sue themselves on the grounds that such an argument "would effectively abrogate Rule 23.1 and weaken the managerial authority of directors"), *overruled on other grounds*, *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

Finally, the argument has no factual basis. Norfolk relies wholly on the untested allegations of wrongdoing made in the Securities Class Action - but that complaint does not claim that any member of the Company's Audit Committee, including those who served on the SLC, was involved in any wrongdoing. Accordingly, even if this argument had been made below, it would have been rejected. It does not present any basis for reversal of the Court of Chancery's decision.

29 II.** ***The Court Of Chancery Correctly Rejected Norfolk's Contention That The Interests Of The Corporation Were Not Adequately Represented In The Hutton Action.

A. ***Question Presented***

Was the Court of Chancery correct when it rejected Norfolk's contention that the interests of the Company were not adequately represented in the *Hutton* Action? (Op. at *28-30)

B. ***Scope of Review***

Questions of law and mixed questions of law and fact are reviewed *de novo*. *Emerald Partners v. Berlin*, 726 A.2d 1215, 1219 (Del. 1999).

C. ***Merits of Argument***

One independent ground identified by the Court of Chancery in its decision was that any future attempt by Norfolk to plead a "demand-excused" derivative suit would be subject to a defense of collateral estoppel

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based on Judge Legg's decision in the *Hutton* Action. This Court does not need to reach that issue, even though the Court of Chancery's decision was plainly correct.

Regardless of whether *Hutton* fully represented the Company's interests, the SLC adequately represented those interests. (Op. at *30) ("Norfolk has not demonstrated a reasonable basis for believing that Jos. A. Bank was not adequately represented by the prior derivative plaintiff or the SLC"). The purpose of Section 220 is to protect stockholder rights, consistent with the fundamental doctrine of Delaware law that management is committed to the Board. When, as in this case, there has been a comprehensive good faith investigation by ***30** an independent SLC, stockholder rights have been fully protected, and the "adequacy" of the stockholder who made the demand giving rise to the investigation becomes irrelevant.

In any event, the Court of Chancery's resolution of the "adequate representation" issue was correct. A stockholder inspection can be denied as a matter of law if the stockholder wishes to pursue a future derivative action but has no legal basis to do so. *See, e.g.*, *West Coast Mgmt. & Capital, LLC v. Carrier Access Corp.*, 914 A.2d 636, 646-47 (Del. Ch. 2006) (inspection denied where future derivative action barred by issue preclusion as to demand futility); *Polygon Global Opportunities Master Fund v. West Corp.*, 2006 Del. Ch. LEXIS 179, *17-20 (Oct. 12, 2006) (inspection denied where future fiduciary duty action barred by lack of standing).

Judge Legg dismissed the *Hutton* Action because the Amended Complaint contained no "particularized allegations" creating a reasonable doubt that a majority of the Board was disinterested and independent for purposes of making a decision on a pre-suit demand. (A311; A315) The Court observed that the Amended Complaint did "not come close to providing the well-pleaded facts to suggest a reasonable inference that a majority of the directors consciously disregarded their duties over an extended period of time that are necessary to create a risk of substantial liability." (A312) (internal quotation omitted).

Here, Norfolk has no legal or factual basis to overcome the collateral estoppel effect of that prior adjudication. As the ***31** Court of Chancery has observed, under federal case law, "collateral estoppel bars all subsequent plaintiffs from relitigating demand futility." (Op. at 20); *see also* *West Coast Mgmt. & Capital, LLC*, 914 A.2d at 643 (citing *Leboyer v. Greenspan*, 2006 WL 2987705, at *1 (C.D. Cal. Oct. 16, 2006), subsequently *superseded by* *LeBoyer v. Greenspan*, 2007 WL 4287646 (C.D. Cal. June 13, 2007), *Henik ex rel. LaBranche & Co. Inc. v. LaBranche*, 433 F.Supp.2d 372, 381 (S.D.N.Y. 2006), and *In re Sonus Networks, Inc. S'holder Deriv. Litig.*, 422 F.Supp.2d 281, 294 (D. Mass. 2006), *aff'd*, *In re Sonus Networks, Inc. S'holder Deriv. Litig.*, 499 F.3d 47 (1st Cir. 2007)).

Under those cases, a derivative plaintiff is precluded from relitigating the issue of demand futility if the defendant can demonstrate the following elements respecting the prior federal decision: "(1) the issue sought to be precluded must be the same as that involved in the prior litigation, (2) the issue must have been actually litigated, (3) the determination of the issue must have been essential to the final judgment, and (4) the party against whom the estoppel is invoked must be fully represented in the prior action." *In re Career Educ. Corp. Deriv. Litig.*, 2007 Del. Ch. LEXIS 184, *34-35 (Sept. 28, 2007) (internal quotation omitted) [7]

***32** All four elements are satisfied here. There is no dispute that the claim of demand futility rejected by Judge Legg is the same one that would be asserted by Norfolk in any future derivative suit. There is no dispute that the issue was actually litigated in the *Hutton* Action. There is no dispute that the Maryland District Court's decision on that issue was essential to its judgment. Thus, the only issue is whether Norfolk was "fully represented" by the plaintiff in the Hutton Action.

Norfolk has provided no basis for concluding that the prior plaintiff did not fully represent the interests of the corporation in the prior derivative action. (Op. at *29-30) A purported derivative plaintiff can avoid the impact of a prior judicial decision rejecting a claim of demand futility only if the prior plaintiff "failed to prosecute or defend the action with due diligence and reasonable prudence, and the opposing party was on notice of facts making that fact apparent." *In re Sonus Networks, Inc. S'holder Deriv. Litig.*, 499 F.3d 47, 65-66 (1st Cir. 2007) (quoting *Restatement (2nd) of Judgments* § 42(1)(e) and cmt. (f)). Inadequate representation is not "failure of a representative to invoke all possible legal theories or to develop all possible resources of proof;" rather, representation is inadequate only when it is "so grossly deficient as to be apparent to the opposing party." *Id.* cmt. (f).

***33** In this case, Hutton filed a derivative suit containing allegations that demand was futile, briefed the ensuing motion to dismiss, and when he lost made a tactical decision to make a demand rather than pursue an appeal. (Op. at *29-30) Nothing in these facts suggests any "gross deficiency" in performance.

Norfolk's argument to the Court of Chancery did not come within miles of showing that Hutton was an inadequate representative. It did not allege that Hutton's (or his lawyers') performance was "grossly deficient" in a way that was "apparent" to the defendants. Rather, its principal complaints about the adequacy of the Corporation's representation by Hutton were (a) that Hutton elected not to make a Section 220 demand on the Company before he filed suit, (b) that Judge Legg ultimately deemed the factual allegations of Hutton's complaint to be inadequate in pleading demand futility, and (c) that Hutton subsequently made a demand on the Company's Board, thereby conceding the Board's independence. (*Id.*)

None of these alleged failings would establish that Hutton did not fully represent Norfolk or the Company or that his performance was grossly deficient. The Delaware courts have never imposed an absolute requirement of a Section 220 demand prior to filing a derivative suit or held that the failure to do so is grossly deficient; on the contrary, in *Career Educ.* the Court of Chancery held that a federal court's dismissal with prejudice for failure to plead futility on a *Caremark* claim barred relitigation of that same issue, even though the federal ***34** plaintiff had not pursued a Section 220 demand. 2007 Del. Ch. LEXIS 184, *38.

Hutton's inability to allege sufficient facts to overcome Delaware's strict demand requirement simply demonstrates the non-existence of such facts, not any deficiency in Hutton's performance. It is significant that even with two more years of time, the SLC Report, its exhibits, the relevant minutes, and the entire public Securities Class Action litigation file in the District Court of Maryland, Norfolk itself has not discovered any reasonable basis for a claim that the Board was not independent.

Finally, by making demand (and thereby conceding Board independence), Hutton plainly was continuing to pursue what he saw as the Company's interests, in accordance with Judge Legg's opinion. This does not in any way establish inadequate representation. As the Court of Chancery observed, "a strategic calculation by one plaintiff's attorney that puts a different plaintiff's attorney at a disadvantage in a later lawsuit does not necessarily mean that the original plaintiff's calculation was harmful to the corporation or a mark of inadequate representation." (Op. at *29-30, n. 68).

In short, Norfolk has not identified anything other than tactical disagreements with Hutton's counsel as a basis for its claim of inadequate representation. It has fallen far short of identifying how Hutton's representation was "so grossly deficient as to be apparent to the opposing party." Therefore, the Court of Chancery was correct in rejecting Norfolk's argument that it ***35** would not be collaterally estopped from arguing demand futility in any future derivative suit.

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CONCLUSION

For all the foregoing reasons, Defendant Below-Appellee Jos. A. Bank Clothiers, Inc. respectfully requests that the decision of the Court of Chancery be affirmed.

Footnotes

1 The Court of Chancery's Opinion, *Norfolk County Retirement System v. Jos. A. Bank Clothiers, Inc.*, 2009 Del. Ch. LEXIS 20 (Feb. 12, 2009), is attached to Norfolk's Opening Brief, and is cited herein according to its LEXIS pagination as "Op. at * __".

2 That single quarter of slightly reduced quarterly earnings was temporary; the Company went on to achieve record earnings of more than $43 million in 2006. (A458)

3 The Company also provided its Form 10-K, which describes its policy of valuing its inventory at the lower of cost or market value. (B459)

4 Norfolk cites *Saito v. McKesson HBOC, Inc.*, 806 A.2d 113 (Del. 2002), for the proposition that the utter futility of its proposed derivative suit should not adversely affect its inspection rights. (Norfolk Op. Br. at 18-19) *Saito* is inapposite, since the shareholders in *Saito* could have used the documents for other purposes, such as seeking corporate reforms. 806 A.2d at 117. Here, Norfolk has articulated no other purpose. (Op. at *40)

5 The ***Grimes*** *II* Court further noted that its conclusions were "broadly consistent with decisions of this Court in defining the scope of allowable discovery in the analogous context of a motion by a special litigation committee to dismiss or settle properly instituted derivative litigation." *Id.* ***Grimes*** *II* quoted Chancellor Allen's observation in *Carlton Investments v. TLC Beatrice Int'l Holdings, Inc.*, 1997 Del. Ch. LEXIS 4 (Jan 28, 1997), that the "committee *report and accompanying documents* should provide a sufficient basis for plaintiff ... to determine whether the investigation was done in good faith and in an informed manner and whether the conclusions reached can be thought fair." *Id.* at *3, *quoted in* ***Grimes***, 724 A.2d at 568 (emphasis added in ***Grimes*** *II*).

6 Plaintiff's reliance on *Abbey v. Computer & Comm'n Tech. Corp.*, 1983 Del. Ch. LEXIS 511 (Apr. 13, 1983), is misplaced. (Norfolk Op. Br. at 34) *Abbey* arose in the context of discovery into a *Zapata* special litigation committee's report, after the SLC took over a properly instituted derivative action. Here, unlike *Zapata* or *Abbey*, the creation of the SLC preceded any derivative action (or 220 action) filed by Norfolk.

7 Historically, the fourth element of collateral estoppel was privity between the prior litigant and the party against whom estoppel is invoked. Privity is satisfied here (as it is in all derivative cases) because the real party in interest in both the *Hutton* Action, and the future derivative action that Norfolk wants to file, is the Company itself. Thus, the Court of Chancery and some other courts have adopted a requirement of the "full representation" rather than "privity" in the derivative context. *See Career Educ.*, 2007 Del. Ch. LEXIS 184, at *32-33.

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2010 WL 4688192 (Del.Ch.) (Trial Motion, Memorandum and Affidavit)
Chancery Court of Delaware.

LOUISIANA MUNICIPAL POLICE EMPLOYEES RETIREMENT SYSTEM, Plaintiff,

v.

MORGAN STANLEY & CO., INC., a Delaware Corporation, Defendant.

No. 5682-VCL.
November 15, 2010.

Louisiana Municipal Police Employees Retirement System's Brief in Opposition to Defendant's Motion to Dismiss

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Dated: November 12, 2010

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PRELIMINARY STATEMENT

Under Delaware law, a shareholder whose pre-suit demand on a Board of Directors is denied has the right to use the "tools at hand"--including, first and foremost, 8 Del. Code § 220--to learn the substantive consideration given, and the reasoning behind, that decision. The shareholder is entitled to explore these matters to determine whether there are continuing grounds to assert derivative claims on the grounds that the Board wrongfully refused to act on the demand. Under Delaware law, this right is not diminished in the circumstance where the shareholder has previously pursued an action unsuccessfully on the grounds of demand futility. If it were, *Grimes v. DSC Communications,* 724 A.2d 561 (Del. Ch. 1998) ("*Grimes II*") (wherein a Section 220 demand with respect to claims previously asserted by plaintiffs and dismissed by the court because pre-suit demand was not excused with respect to them) could not have been decided the

way it was--namely, granting the Section 220 demand and allowing the plaintiff inspection of wide-ranging books and records.

Despite its voluminous citations of Delaware decisions, Defendant Morgan Stanley & Co. ("Morgan Stanley" or "Defendant") has yet to cite a case in which a Delaware court has overturned or otherwise called into question the ***Grimes*** court's making Section 220 requests available to shareholders in this situation. Instead, the cases cited by the Board's counsel chiefly address the situation where the Section 220 request pertains to whether pre-suit demand on the Board would have been futile because the Board is not disinterested and independent and the Section 220 request has been made *after the commencement of a shareholder derivative suit alleging that the demand on the Board would have been futile.* [1] Here, unlike those cases, Plaintiff seeks Section 220 inspection rights, *not* to support a claim of demand futility (thus not implicating the *King* line of cases)--nor even after having commenced (or to support) an already-filed derivative case premised on wrongful refusal--but instead, to determine whether it would be appropriate to file a wrongful refusal derivative case. Contrary to Defendant's suggestion, therefore, the Retirement System, rather than rush into Court with a wrongful refusal case, is actually acting conservatively and in an effort to avoid unnecessary costs and burdens.

As demonstrated herein, there is no reasonable basis for the Board's rejection of the Retirement System's Section 220 request, and the Complaint herein clearly states a claim. Defendant relies on inaccurate characterizations of the case law and of Plaintiff's expressed intent for how it will use the inspection provided under Section 220, and canards such as an "end-run" around discovery or a "fishing expedition" that have no currency in the factual circumstances of this case.

STATEMENT OF FACTS

Plaintiff Louisiana Municipal Police Employees Retirement System (the "Retirement System" or "Plaintiff") is a current shareholder of Morgan Stanley & Co. ("Morgan Stanley" or the "Company") and brings this action in its capacity as a shareholder. Morgan Stanley is incorporated in Delaware, and the Retirement System has owned shares of its common stock continuously since April 2006. Compl. ¶¶ 1-2.

On August 27, 2008, the Retirement System commenced a shareholder derivative action on behalf of Morgan Stanley in the United States District Court for the Southern District of New York. The action was captioned *Louisiana Municipal Police Employees Retirement System v. Mack, et al.,* No. 08-cv-7587 (S.D.N.Y. filed Aug. 27, 2008) (the "New York Action"). Subsequently, a consolidated amended complaint was filed in the New York Action, naming Terry G. Thomas as an additional party plaintiff. Compl. ¶ 3. A copy of the consolidated amended complaint in the New York Action (the "federal complaint") was attached as Exhibit A to the Retirement System's complaint in this action. Compl. Exh. A.

The New York Action seeks relief against several current and former officers and directors of Morgan Stanley arising from their alleged misconduct in causing the Company to deceive its own customers and investors with respect to the market for auction-rate securities ("ARS"). Compl. ¶ 4 & Exh. A. The misconduct ultimately exposed the Company to multiple state and federal regulatory proceedings and led it to agree to pay monetary penalties totaling over $35 million and repurchase approximately $6.4 billion of ARS previously sold to customers. *Id.* The economic impact on Morgan Stanley from its managers' manipulation of the ARS market is alleged to equal or exceed $6.6 billion. *Id.*

On March 23, 2009, all defendants in the New York Action, including Morgan Stanley as nominal defendant, moved to dismiss the federal complaint under Federal Rule of Civil Procedure 23.1 for failure to adequately allege reasons why pre-suit demand on the Morgan Stanley Board of Directors was excused as futile. Compl. ¶ 5. The defendants also moved to dismiss the Complaint under Rule 12(b)(6) for failure to state a claim upon which relief can be granted. *Id.*

On June 23, 2009, ruling from the bench, the New York court (Hellerstein, J.) granted the defendant's Rule 23.1 motion, holding that demand was not excused. Compl. ¶ 6. Judge Hellerstein declined to grant the defendants' motion to dismiss the claims under Rule 12(b)(6). The court held that pre-suit demand was necessary for the claims to proceed. *Id.*

However, the New York court invited Plaintiff to make a pre-suit demand on the Morgan Stanley Board of Directors. As reflected in the written order issued that same day:

> Plaintiffs will have until July 24, 2009 to make demand of Morgan Stanley. If the Board of Directors of Morgan Stanley chooses to investigate the allegations made in the demand, it will have until January 25, [2010] (and any enlarged period granted by the court) to conduct the investigation and issue a report. Within thirty days (and any enlarged period granted by the court) from when Morgan Stanley issues its report of investigation, plaintiffs may move for appropriate relief, including leave to file an amended complaint. I shall retain jurisdiction over these proceedings.

Compl. ¶ 7.

The New York court reaffirmed its ruling in this regard on July 22, 2009, when it granted the Retirement System's motion for reconsideration in part to hold specifically that Plaintiff had adequately alleged that at least three (and possibly four) members of Morgan Stanley's 11 -member Board were, in fact, conflicted from considering pre-suit demand. Compl. ¶ 9 & Exh. C. In addition, the court repeated its ruling quoted above, *verbatim* except for the new deadline of August 26, 2009 for Plaintiff to make demand and February 26, 2010 for the Board to respond. *Id.*

Pursuant to the New York court's guidance, on August 24, 2009, the Retirement System made formal demand on the Morgan Stanley Board, to investigate and file suit with respect to the ARS claims. Compl. ¶ 10 & Exh. D. The Morgan Stanley Board, acting through the corporate Secretary, acknowledged the Retirement System's demand, by letter dated September 9, 2009. *Id.* ¶ 11. After an extension was granted in the time to do so, the Board, through counsel, responded to Plaintiff's shareholder demand regarding ARS on April 26, 2010. The Board refused the demand in its entirety. *Id.* ¶ 13 & Exh. E.

The demand refusal letter, although it described the procedural mechanism which the Board had used in addressing the demand, did not set forth the substantive consideration given to the demand or the reasoning behind the Board's decision to reject it. Compl. ¶ 14 & Exh. E.

After receiving the Board's demand refusal letter, counsel for the Retirement System thereupon made the Section 220 request that is the subject of the instant action. Compl. ¶ 15 & Exh. F. This request sought several categories of documents, including the actual report and recommendation relied upon by the Board to deny the demand; the minutes of any Board or Board committee meeting at which the Retirement System's

demand (or the Company's investigation thereof) was discussed; any documents or witness interviews relied upon by the Board, any Committee, or any of their counsel, to evaluate the demand or recommend denial of the demand; and documents concerning the payment or recusal of Board and Committee members or their counsel. *See id.*

On May 19, 2010, counsel for the Morgan Stanley Board wrote to counsel for Plaintiff rejecting the Section 220 Demand in its entirety. Compl. ¶ 16 & Exh. G. Significantly, the Board refused even to provide a copy of the report that it had reviewed and relied upon for its "findings and recommendation regarding the matters raised in the Demand Letter." *Id.* (quoting Board's denial of pre-suit demand).

The Board purported to base its refusal of the Section 220 request on the length of time that the New York Action had been pending--disregarding the fact that the Board itself had only responded to the shareholder demand on April 26, 2010 (after it requested and received a two-month extension). Compl. ¶ 17. The Board's refusal of the Section 220 Demand also purported to be based on the unavailability--under *the Federal Rules of Civil Procedure*--for discovery into the particulars behind the Board's refusal to grant the initial shareholder demand. *Id.* ¶ 18. Finally, the Board objected to the Retirement System's request for a case management conference before the New York court, on the grounds that that court did not have jurisdiction to adjudicate a Section 220 demand. Compl. ¶ 19.

In an effort to resolve the disagreement on a consensual basis, counsel for the Retirement System thereupon contacted counsel for the Board to invite an informal information exchange that might avoid further litigation. Specifically, Plaintiff's counsel asked to see--on a confidential, attorney's-eyes-only basis--only the Report relied upon by the Board in refusing demand. *Id.* ¶ 20. That invitation, too, was rejected by counsel for the Board, who now for the first time asserted that the Section 220 demands originally transmitted had been overbroad. *Id.* ¶ 20 & Exh. H. With no evidentiary basis, counsel for Board accused Plaintiff's counsel of having made "a thinly veiled attempt to get discovery as to the underlying merits of their claims relating to auction rate securities." *Id.,* Exh. H, at 2. [2]

Subsequently, the New York court denied Plaintiff's request for a case management conference, on the grounds that it did have not jurisdiction to adjudicate a Section 220 demand, and ordered Plaintiff to show cause by July 31, 2010 why the New York Action should not be dismissed. Compl. ¶ 21.

On July 30,2010, the Retirement System filed the instant action, seeking to obtain by Court order the books and records that the Board had refused to produce despite Plaintiff's clear need and right to inspect such books in the demand-refused context. In addition, on July 31, 2010, the Retirement System filed a response to the order to show cause in the New York court, which is attached as Exhibit K to the Affidavit of Kevin M. Gallagher submitted in support of the Motion ("Gallagher Aff."). In its response, Plaintiff set forth the legal reasoning for its request for inspection under Section 220 in the demand-refused context of this case. *See* Gallagher Aff. Exh. K. Citing its filing of the instant action, the Retirement System requested that Judge Hellerstein hold the New York Action in abeyance pending further developments concerning the Section 220 demand issue by this Court. *See id.* The Morgan Stanley defendants filed a response to this response, urging that the New York Action be dismissed but, confusingly, also stating that "it would make sense" for that action to be held in abeyance. *Id.* Exh. L, at 9.

On September 14, 2010, Judge Hellerstein issued an order granting the Retirement System's request to hold the New York Action in abeyance pending further developments with respect to Plaintiff's Section 220 request. Gallagher Aff. Exh. M. In so doing, the New York court declined to adopt the defendants' arguments (repeated in the instant Motion in this Court) that a plaintiff may *never* make a Section 220 after having commenced a derivative action, that Plaintiff's Section 220 requests were merely an "end-run

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around the federal discovery rules" or an "improper fishing expedition," and that Plaintiff had not made the requests for a "proper purpose." *See id.;* Exh. L (defendants' response to Plaintiffs' response to order to show cause).

ARGUMENT

I. DELAWARE LAW PERMITS SECTION 220 INSPECTION OF BOOKS AND RECORDS RELEVANT TO A BOARD'S REFUSAL TO BRING CLAIMS IN RESPONSE TO A DEMAND TO DO SO, EVEN IF THE CLAIMS WERE PREVIOUSLY LITIGATED AND DISMISSED ON THE GROUNDS THAT PRE-SUIT DEMAND WITH RESPECT TO THEM WAS NOT EXCUSED.

Under well-settled law, when a pre-suit demand is refused by a corporate Board of Directors, a shareholder has the right to file a derivative action premised upon a showing that the Board's refusal was wrongful. *Aronson v. Lewis,* 473 A.2d 805, 813 (Del. 1984). *See generally* Ralph C. Ferrara, et al., *Shareholder Derivative Litigation: Besieging the Board* § § 7.02-7.03, at 7-3 to 7-8 (discussing the wrongful refusal rule and discovery in the demand-refused context) (2007). The Board may then move to dismiss that action on the grounds that its decision to refuse the demand--like other decisions it makes--is protected by the business judgment rule. *Aronson,* 473 A.2d at 813; *Zapata Corp. v. Maldonado,* 430 A.2d 779, 784 & n.10 (Del. 1981) ("when stockholders, after making demand and having their suit rejected, attack the board's decision as improper, the board's decision falls under the 'business judgment' rule and will be respected if the requirements of the rule are met").

However, the principle of the business judgment rule applying to decisions of Boards regarding shareholder litigation does not mean that the business judgment rule always protects those decisions. Ferrara et al., *supra,* § 7.02, at 7-5. To the contrary,

> [t]he presumptions underlying the business judgment rule are no less vulnerable to attack in the context of shareholder derivative litigation than in any other context. The wrongful refusal rule simply means that a decision regarding whether a corporation should or should not pursue particular legal claims is in the first instance within the authority of the board to make, and a shareholder can interject himself into the decision making process if he can challenge the presumptions underlying the business judgment rule.

Id. Therefore, in order to establish that a decision to refuse a demand is wrongful, a plaintiff must establish a reasonable doubt that a majority of the Board was disinterested and independent; or he must show that the Board lacked good faith, acted without due care in responding to the demand, or that its decision to rebuff the demand was otherwise not in the best interests of the corporation. *See, e.g., Scattered Corp. v. Chicago Stock Exchange, Inc.,* 701 A.2d 70,73 (Del. 1997); ***Grimes*** *v.* ***Donald****,* No. Civ. A. 13358,1995 WL 54441, at * (Del. Ch. Jan. 11, 1995), *aff'd,* 673 A.2d 1207 (Del. 1996); *Levine v. Smith,* 591 A.2d 194, 198 (Del. 1991).

Due to the necessity of making that particularized showing, a shareholder plaintiff, before filing a derivative complaint premised upon wrongful refusal of demand,

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> has the right to use the "tools at hand" to obtain the relevant corporate records, such as reports or minutes, reflecting the corporate action and related information in order to determine whether or not there is a basis to assert that demand was wrongfully refused.

***Grimes** v. **Donald**,* 673 A.2d 1207, 1218 (Del. 1996) (*"**Grimes** I"). See also Scattered Corp.,* 701 A.2d at 77. Among the "tools at hand" available for this purpose is Section 220 of the Delaware General Corporation Laws, which establishes a procedural mechanism for shareholders who establish a "proper purpose" to inspect corporate books and records. *See* 8 Del. Code § 220. In several cases, the Delaware Supreme Court has indicated that Section 220 may be used to obtain relevant corporate records in the demand refused context. *See Brehm v. Eisner,* 746 A.2d 244, 266 (Del. 2000); *Scattered Corp.,* 701 A.2d at 78; ***Grimes** I,* 673 A.2d at 1216 n. 1; *Rales v. Blasband,* 634 A.2d 927, 935 n.10 (Del. 1993). In 1998, the Delaware Chancery Court confirmed that Section 220 can be used by plaintiffs in shareholder derivative suits to obtain information for use in challenging a Board's response to a demand-- *including in the situation where shareholders'previous suits based on excusal of demand have been dismissed. See **Grimes** II,* 724 A.2d at 571 (granting judgment to plaintiff in Section 220 action against corporation to obtain books and records relevant to Board's refusal of shareholder demand).

In the ***Grimes*** litigation, the plaintiff--as here--had originally filed a derivative suit, claiming that demand was excused. *See **Grimes** I,* 673 A.2d at 1216.[3] After the Supreme Court held that demand was required, the plaintiff made a demand on the Board. In response, the Board formed a special committee, which in turn produced a report to the Board recommending that it reject the plaintiff's demand. The Board then wrote a letter to the plaintiff stating that it had determined to reject the demand based on the committee's report and recommendation. The Board's letter refusing the demand read, in its entirety:

As you know, the Board of Directors of DSC Communications Corporation (the "Board") appointed a special committee of independent directors (the "Special Committee") to investigate the issues raised in your demand letter to the Board dated June 5, 1996 (the "Demand"). The Special Committee conducted an extensive investigation, including a review of relevant documents and interviews of numerous individuals with knowledge of the issues raised in the Demand.
Based upon its investigation and consideration of applicable law, the Special Committee prepared a comprehensive report to the Board recommending that the Board reject the Demand. The report was presented to the Board at its meeting on April 30, 1997. After full discussion at that meeting and a meeting held on May 15, 1997, the Board decided to accept the recommendation of the special committee.

Accordingly, the Board has rejected your demand and has declined to take any of the actions requested in the demand.

***Grimes** II,* 724 A.2d at 564 & n.2.

The plaintiff then submitted a request to the corporation pursuant to Section 220 for the committee's report and other material relating to the Board's decision to reject the demand. *See **Grimes** II,* 724 A.2d at 564. The stated purpose of the request was "to determine the independence of the Special Committee and whether the Special Committee and the Board have complied with Delaware law in their analysis and rejection of the Demand." *Id.* at 564-65. The corporation produced some materials, but refused to produce others,

including the committee report. The corporation argued that the plaintiff's purpose was improper, and that the requested material was protected by the attorney-client privilege and work product doctrine. *Id.* at 565.

The Chancery Court (Lamb, V.C.) held that the purpose for **Grimes's** demand was a proper purpose under Section 220, noting that plaintiffs in demand-required cases are required to plead wrongful refusal with particularity, but without the benefit of formal discovery, and citing earlier cases suggesting that Section 220 was one of the "tools at hand." ***Grimes*** *II,* 724 A.2d at 566. The court reasoned as follows:

> [T]he plaintiff has taken to heart the Supreme Court's admonition. He made a demand and, nearly one year later, was told without explanation, or "peremptorily," that the board of directors, on the recommendation of the Special Committee, had refused his demand. Plaintiff is now attempting to "use the tools at hand," in order to determine whether his demand was wrongfully refused. ***Grimes*** and *Scattered Corp.* clearly indicate that a Section 220 request for documents under these circumstances is proper.

Id. at 566-67.

The court also held that "the right to obtain corporate records for the purpose of determining whether or not a demand was improperly refused focuses on the committee process itself and extends at least to 'reports or minutes, reflecting the corporate action.' " ***Grimes*** *II,* 724 A.2d at 567. The court thus held that shareholders were:

> entitled to receive copies of the Special Committee's report, minutes of the meetings of the Special Committee and minutes of any meeting of the board of directors relating to the creation or functioning of the Special Committee, including any meeting of the board of directors at which the recommendation of the Special Committee was considered or approved.

Id. at 567. In addition, shareholders were entitled to "documents reflecting payments made to or on behalf of the members of the Special Committee." *Id.* Finally, the court rejected the corporation's attorney-client privilege and work-product claims, holding that the plaintiff had demonstrated the "good cause" and "substantial need" required of shareholders seeking to obtain privileged corporate documents. *Id.* at 568-69.

II. THE RETIREMENT SYSTEM'S REQUEST FOR SECTION 220 BOOKS AND RECORDS FITS WITHIN THE *GRIMES* FACT PATTERN.

In this derivative litigation, the Retirement System has "taken to heart the Supreme Court's admonition" in ***Grimes*** to use Section 220 to test a Board's refusal to bring claims. ***Grimes*** *II,* 724 A.2d at 566. As in ***Grimes****,* when Plaintiff's original complaint alleging demand excusal was dismissed, Plaintiffs herein made a demand on the Morgan Stanley Board. *See* Gallagher Aff. Exh. C. Indeed, the New York court specifically contemplated that the Board would issue a report with respect to its investigation of Plaintiffs' demand, and that the Board's response might serve as the basis for a renewed complaint based on wrongful refusal. *See* Order Granting Rehearing and Confirming Prior Order dated July 22, 2009, Gallagher Aff. Exh. B,

at 3 (within thirty days of Board's issuance of report in response to demand, "[P]laintiffs may move for appropriate relief, including leave to file an amended complaint").

Subsequently, the Board determined to reject the Retirement System' demand. *See* Compl. Exh. E. As had been the situation in ***Grimes****,* the Board's demand refusal letter--although it described the procedural mechanisms which the Board had used in addressing the demand--did not set forth the substantive consideration given to the demand or the reasoning behind the Board's decision to reject it. *See id.* Heeding the Delaware Supreme Court's repeated admonitions over the years to use the "tools at hand" to investigate the actual basis of the Board's refusal of demand before filing a renewed derivative complaint premised upon wrongful refusal of demand, the Retirement System thereupon made a Section 220 request on the Board. *See id.* Exh. F. The Board rejected this request in its entirety, refusing even to provide a copy of the report that it had reviewed and relied upon for its decision to reject the pre-suit demand. *See id.* Exh. G.

In sum, in this litigation, as in ***Grimes****,* events unfolded as follows:

• A derivative action is commenced including claims as to which the shareholder plaintiff had alleged that pre-suit demand was excused;

• The court dismisses the claims on the grounds that, in the circumstances, demand is not excused;

• The plaintiff thereupon makes pre-suit demand with respect to the claims, and the Board, after a lengthy period of review, rejects the demand;

• The Board sends a letter to plaintiff describing the procedures it used in deciding not to bring the claims itself-but it omits any discussion of the underlying facts reviewed by the Board, the application of the law to the facts, and the substantive factors considered in determining whether to assert the claims or how they were weighed;

• The plaintiff makes a request for books and records relevant to the Board's refusal of pre-suit demand with respect to the claims;

• The Board rejects the books and records request in whole (here) or in part (***Grimes***).

Thus, based on the facts in the instant case, the Retirement System is not barred from making a Section 220 request to determine the propriety of the Morgan Stanley Board's refusal to bring the claims at issue in the same way that the shareholder in the ***Grimes*** litigation was not barred from proceeding with his Section 220 request concerning the demand he made after his first action was dismissed for failure to make a pre-suit demand.

The Retirement System's position is founded upon the following bedrock principle noted by the Delaware Supreme Court ***Grimes*** *I:*

> Simply because the composition of the board provides no basis *ex ante* for the stockholder to claim with particularity and consistently with Rule 11 that it is reasonable to doubt that a majority of the board is either interested or not independent, it does not necessarily follow *ex post* that the board in fact acted independently, disinterestedly or

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with due care in response to the demand. A board or a committee of the board may appear to be independent, but may not always act independently.

***Grimes** I,* 673 A.2d at 1219.

This principle is applicable in this case. Simply because the New York court held that the composition of Morgan Stanley's Board provided no basis *ex ante* for the Retirement System to claim that it was reasonable to doubt that a majority of the Board was either interested or not independent, it does not necessarily follow *ex post* that the Morgan Stanley Board acted independently, disinterestedly or with due care in response to Plaintiff's demand of August 24, 2009. Plaintiff's Section 220 request is the very means repeatedly recommended by the Delaware Supreme Court to find the answer to that question.

Defendant's attempts to distinguish ***Grimes*** fall short. First, it argues that the Board's refusal of demand was not "peremptory," as in ***Grimes**,* but contained "a detailed description of the process" that the Board followed in rejecting the demand. Motion at 5, 16-19. Second, it urges that unlike the situation in ***Grimes**,* where the demand letter had come only "after a one year delay," the Board's response was "timely." *Id.* at 17.

As to the Board's purported "timeliness," the Board did not issue a response to the Retirement System's demand letter until April 26, 2010, some eight months after demand was made. *See* Compl. Exh. E. This eight-month delay was not materially more punctual than the "one year delay" involved in ***Grimes**.* Moreover, the Board issued its response some two months after Judge Hellerstein's original deadline for doing so of February 26, 2010.[4] In all events, the length of the DSC Board's reply to **Grimes's** demand letter played no importance whatsoever in the Chancery Court's decision, *see **Grimes** II,* and should not do so here either.

As for Defendant's argument that the Board's response to the demand was based on purportedly extensive procedures, the scope of the Board's investigation is not dispositive as to the wrongful refusal issue--particularly where, as here, the Board has refused to produce even the pivotal Report on which, by its own admission, its rejection of the demand was based. *See* Compl. Exh. E. Although the process was detailed, as facially described by the Board's counsel in its rejection of the demand, the Retirement System is entitled to more than the Board's recitation (prolix as to procedures but silent as to substance) of the steps it took to investigate the demand and thereby attempt to immunize itself from further inquiry.

In particular, Plaintiff is entitled to inquire as to the underlying facts reviewed by the Board, the application of the law to the facts, and the substantive factors considered (and how they were weighed) by the Board, in deciding to reject the demand. *See **Grimes** II,* 724 A.2d at 567-68 (stating that "the right to obtain corporate records for the purpose of determining whether or not a demand was improperly refused focuses on the committee process itself and extends *at least to "reports or minutes, reflecting the corporate action"* and noting that the proper scope of inspection in the wrongful refusal context is "analogous" to the proper scope in the context of a Board's motion to dismiss after a special litigation committee has determined to dismiss or settle properly instituted derivative litigation).[5] With regard to that substantive information, the Morgan Stanley Board's refusal of demand is no less "peremptory" than the DSC Board's in ***Grimes**:* neither Board furnished the substantive factual information, weighing of considerations, or application of law to facts necessary to properly determine whether refusal was wrongful. Most importantly, the Morgan Board, like the Board of DSC Communications, refused to produce the very report it relied upon to reject the derivative demand.

III. DEFENDANT'S ARGUMENTS FOR DISMISSING THIS ACTION, EVEN BEFORE ANY EVIDENCE IS PRESENTED, ARE WRONG AND ITS CASE LAW IS INAPPOSITE.

Aside from its ineffective attempt to distinguish ***Grimes*** (discussed in the previous section), Defendant makes a series of arguments for dismissing this action before any evidence has been presented. Each of these arguments is incorrect.

First, Defendant argues that the Retirement System has failed to allege facts providing a "credible basis to believe that the Board did not use an appropriate process" in rejecting the derivative demand. Motion at 15. Defendant argues that since a Board's decision to reject demand is, like other Board decisions, entitled to the presumption of good faith and reasonableness, a Section 220 plaintiff must come forward with specific facts to show a credible basis for an inference that the Board suffered from some self-interest or failed to exercise due care in that decision. *See id.* at 15-16. Defendant protests that the Retirement System has not done so. *See id.*

This argument is incorrect because it wrongly seeks to apply standards for showing a "credible basis" to question a Board's decisions that appropriately are applied only in factual contexts quite different from the case at bar. Thus, the cases cited by Defendant to support its argument, *Wynnefield Partners Small Cap Value L.P. v. Niagra Corp.,* 2006 WL 1737862 (Del. Ch. June 19), *aff'd in part, rev'd in part,* 907 A.2d 146 (Del. 2006) (TABLE), and *Seinfeld v. Verizon Commc'ns, Inc.,* 909 A.2d 117, 118 (Del. 2006), provide no support for dismissal here. In *Wynnefield,* the Section 220 request was based only on an expressed need to investigate corporate wrongdoing, and the request was denied only in part, and only after a full trial of evidence concerning whether the plaintiff had a credible basis of wrongdoing to justify obtaining books and records. *See Wynnefield,* 2006 WL 1737862, at *1, *8, *14-*15. In *Seinfeld,* lack of evidence of wrongdoing similarly led the court to deny the plaintiff's Section 220 request in the context of a motion for summary judgment; plaintiff himself admitted in his deposition that "he had no factual support for his claim that mismanagement had taken place." *Seinfeld,* 909 A.2d at 119.

Unlike as in *Wynnefield* and *Seinfeld,* the Retirement System seeks books and records, not only to investigate corporate wrongdoing, but also to investigate the circumstances surrounding the Board's refusal of its derivative demand. Defendant concedes this point. *See* Motion at 7 ("Plaintiff also includes request concerning the rejection of the Demand Letter."); *see also id.* at 5 (quoting Section 220 demand letter). As to this latter purpose, the ***Grimes*** standards apply and, as shown above, support Plaintiff's request. Even were the instant Section 220 request directed solely to corporate wrongdoing, *Wynnefield* and *Seinfeld would* not support dismissal. As noted above, those cases were decided based on factual showings, or the lack thereof, after the presentation of evidence (either at trial or in the summary judgment context). Here, where there has been no occasion for Plaintiff to present evidence, it would be premature to dismiss the claims, and these cases cannot justify doing so.

Moreover, Plaintiff's Section 220 request, to the extent it is premised on a need to investigate wrongdoing, amply sets forth a basis to believe that wrongdoing occurred: in its Section 220 request letter, Plaintiff referred to, discussed, and attached its original complaint in the New York Action, thereby bringing to the Board's attention the multiple investigations of Morgan Stanley for fraud and other improprieties in the ARS market, including in both 2006 and 2008 and including by the SEC and several states' attorneys general, culminating in two sets of fines, censures, and/or settlements requiring multi-billion dollar securities buybacks and several hundred million dollar penalties. *See* Compl. Exhs. A & F. As Defendant's own cases hold, such facts satisfy the standard for obtaining books and records to investigate corporate wrongdoing. *See Freund v. Lucent Technologies, Inc.,* 2003 WL 139766, at *3 (Del. Ch. Jan. 9, 2003) (a purpose of

investigating the misconduct identified in an SEC order is "sufficiently concrete" to serve as a proper purpose justifying inspection) (relied upon by Defendant, Motion at 9); *Seinfeld,* 909 A.2d at 124 & n.4 ("there are a myriad of cases where stockholders have successfully presented 'some evidence' to establish a 'credible basis' to infer possible mismanagement") (citing fifteen cases) (relied upon by Defendant, Motion at 16, 19). *See also Security First Corp. v. U.S. Die Casting and Development Co.,,* 687 A.2d 563,567-68 (De. Supr. 1997).

Finally, even if the Retirement System's Section 220 request, to the extent premised on corporate wrongdoing, were deemed not for a proper purpose, that would not justify dismissing this action. "Once a stockholder establishes a proper purpose under § 220, the right to relief will not be defeated by the fact that the stockholder may have secondary purposes that are improper." *Saito v. McKesson HBOC, Inc.,* 806 A.2d 113, 116 (Del. 2002)

Second, Defendant argues that "there is a presumption that a board's decision" to reject demand "was the product of the exercise of a valid business judgment" and that Plaintiff, merely by making a demand to bring derivative claims, has "conceded" that the Board was sufficiently independent and disinterested to respond. *See* Motion at 14-15 & n.5 (citing, *inter alia, Levine v. Smith,* 591 A.2d 194, 207 (Del. 1991)). But the Delaware Supreme Court has made clear that, whatever possible concession a plaintiff makes as to a Board's independence by making a derivative demand, the good faith and reasonableness of the Board's actual response to the derivative demand still are very much at issue and may be litigated in a Section 220 case:

> It is not correct that a demand concedes independence "conclusively" and *in futuro* for all purposes relevant to the demand. *Levine* and *Spiegel* state that, in assessing whether a demand has been wrongfully refused, the Court looks only to good faith and the reasonableness of the investigation. This is completely consistent with the ***Grimes*** teaching that a board that appears independent *ex ante* may not necessarily act independently *ex post* in rejecting a demand. Failure of an otherwise independent-appearing board or committee to act independently is a failure to carry out its fiduciary duties in good faith or to conduct a reasonable investigation. Such failure could constitute wrongful refusal.

Scattered, 701 A.2d at 74-75.

Third, Defendant suggests that in no circumstances may a shareholder plaintiff ever file a Section 220 request *after* filing a derivative action. *See* Motion at 9-14.[6] This argument, too, is incorrect. In making it, Defendant relies on misleading descriptions of case holdings, overbroad characterizations of the order in which derivative actions and Section 220 actions may be pursued, and an inaccurate and unjustified characterization of the Retirement System's expressed intent in this litigation.

The unjustified characterization occurs on page 13 of the Motion, where Defendant distorts the Retirement System's express statement that it is *not* certain that it will file a new derivative action premised on wrongful refusal of demand. Plaintiff's actual statement in this regard was contained in its response to Judge Hellerstein's order to show cause, wherein Plaintiff stated that, if the Delaware Chancery Court's "decision is to deny Plaintiffs all inspection rights under Section 220, then Plaintiffs will consider their options and advise the Court promptly (within 30 days) in the event that they still intend to file a renewed complaint

based on wrongful refusal." Gallagher Aff. Exh. K, at 10. Through careful editing, Defendant has overtly misquoted this statement, claiming that "Plaintiff has admitted that it " 'intend[s] to file a renewed complaint [in the Derivative Action] based on wrongful refusal.' " Motion at 13 (edits by Defendant). *See also id.* at 13-14 ("Plaintiff commenced this action in a blatant attempt to ... avoid its inability to obtain discovery for its to-be-filed wrongful refusal complaint").

Defendant's mischaracterization of Plaintiff's words goes to the heart of why its arguments concerning the order in which the proceedings in this litigation have unfolded fail. Much as Defendant would like the facts to be otherwise, there is no currently pending derivative litigation against Morgan Stanley management related to ARS, [7] and the Retirement System has not, in fact, made any decision one way or the other to pursue any further derivative litigation related to ARS. These fundamental facts serve to undercut the rationale for all of Defendant's arguments in this regard, both as a matter of law and a matter of public policy.

As a matter of law, not a single one of Defendant's cases addresses the situation that pertains herely, *viz.,* a Section 220 action brought to obtain books and records concerning a Board's refusal to bring claims which the plaintiff previously had asserted in a derivative action and which the court in that action previously had dismissed because of the plaintiffs failure to make demand or allege reasons why demand was excused. This unique circumstance, which *is* addressed in ***Grimes*** *II* and supports obtaining the books and records, makes all of Defendant's cases inapposite. Thus, while it is true that many Delaware cases admonish that shareholders must make a Section 220 request "before" commencing derivative litigation, the context of those cases makes clear that the reason for this stricture is to prevent plaintiffs from using Section 220 to obtain information to rectify pleading deficiencies in existing derivative litigation. One case, *Baca v. Insight Enterprises, Inc.,* 2010 WL 2219715, at *3 (Del. Ch. June 3,2010), even noted that "there are special circumstances under which a Section 220 demand would not be foreclosed by a prior derivative action" and cited examples. *Id.* at *6 & n. 1.

The paradigm for this misuse of Section 220 is a plaintiff who has filed derivative claims premised upon demand futility and who, once those claims are dismissed on the grounds that facts were not alleged establishing the futility of demand, then (sometimes even encouraged by the court) seeks books and records whose evident purpose is solely to support renewed claims based on demand futility. *See King,* 994 A.2d at 361-67 (granting motion to dismiss books and records action as not brought for a proper purpose, when it was brought in order to help stockholder replead a viable claim for demand excusal in federal derivative action); *Baca,* 2010 WL 2219715, at *3 (granting motion to dismiss books and records action which had been brought only to investigate matters plaintiff had already put in issue in existing derivative litigation and only to avoid dismissal of the existing litigation for failure to plead demand futility). Other misuses of Section 220 presented by Defendant's cases-and not applicable here since there is no pending derivative litigation as to which the Retirement System intends to use books and records to support-- include seeking books and records as an end-run around discovery in federal cases as to which discovery otherwise was stayed under the Private Securities Litigation Reform Act. *See Beiser v. PMC-Sierra, Inc.,* 2009 WL 483321, at *3 (Del. Ch. Feb. 26, 2009).

To the extent these cases contain language seemingly proscribing the use of Section 220 to obtain books and records in any and all circumstance following the commencement of a shareholder derivative action, *see, e.g., King,* 994 A.2d at 356-57 (cited in Motion at 11-12), it would be inappropriate to interpret them to make such a broad holding the law of this State. If the intent of these courts was to preclude the use of Section 220 even in the ***Grimes*** situation, the fact patterns of these cases did not address the ***Grimes*** Section-220-request-after-Board-refusal-of-demand fact pattern, and the courts cited **Grimes** only favorably. *See King,* 994 A.2d at 356 n.2,362 n.31,363 n.33; *Baca,* 2010 WL 2219715, at *5.

Nor are Defendant's cases rendered any more applicable for their focus on the "costs" that the derivative defendants have borne so far in responding to shareholder plaintiffs' claims and requests. *See, e.g., King,* 994 A.2d at 361; *Beiser,* 2009 WL 483321, at *3. As these cases make clear, a corporate defendant's costs in the derivative context become relevant only where derivative plaintiff has "prematurely filed a thinly-substantiated complaint [] ... only in order to beat their competitors in the plaintiffs' bar, and then attempt[s] to compensate for those inadequate pleadings through an after-the-fact process that needlessly saps corporate funds ...." 994 A.2d at 362-63. Such is not the situation here. Again: through its Section 220 request, Plaintiff seeks to determine the reasonableness and good-faith of the Board's rejection of its pre-suit demand. This is a legitimate use of Section 220 under well-settled authority such as *White,* and, under ***Grimes****,* the legitimacy of such use is not cast into doubt by Plaintiff's prior filing of a derivative action premised demand excusal that was dismissed. To be sure, Morgan Stanley has borne costs as a result of this litigation, but this alone scarcely can serve as a basis to dismiss this action. As one court noted, in rejecting a similar argument to dismiss a Section 220 action based on the burdens of having to defend multiple claims and proceedings, "[w]hile this result might simplify life for Lucent's legal department, it is not necessarily consonant with the best interests of the corporation." *Freund,* 2003 WL 139766, at *4.

The same is true here. Corporate costs of a type that were at issue in *King* and *Baca* (to provide books and records to a shareholder plaintiff in his demand-excused claims) could not have been avoided in the instant case by the Retirement System's filing a Section 220 request before its demand-excused claims were filed (or before the Board had completed an investigation in response to a derivative demand) because, by its nature, Plaintiff's Section 220 request could not have been made (because not ripe) until the Board had actually refused a derivative demand. This is why Defendant's argument is also wrong as a matter of public policy. If the broad rule Defendant urges were adopted, than there could never be a derivative demand *after* dismissal for failure to plead demand excusal because, *without Section 220,* there would no way to overcome a wrongful refusal even in the most egregious cases of peremptory refusal. This, in turn, would conflict with Delaware's policy of allowing shareholders the option of satisfying Rule 23.1 by pleading demand futility: very few shareholder plaintiffs would risk commencing a derivative action premised upon demand futility knowing that, if the claims were dismissed, any subsequent attempt to obtain redress by a derivative demand on the Board could be peremptorily refused by the Board (without even having to investigate and consider the demand) with complete impunity (since no Section 220 remedy would be available).

Fourth, Defendant relies on the familiar accusation that the Retirement System's Section 220 request somehow constitutes an "end-run" around the discovery rules in existing derivative litigation or is an "improper fishing expedition" where Plaintiff otherwise has no credible evidence of wrongdoing or wrongful refusal of demand. Motion at 14-19. Again, Defendant has conflated distinct issues and relied on cases that do not apply in the factual situation at bar.

As an initial matter, as noted above, there is no existing derivative litigation to which discovery rules apply and around which Plaintiff is, or could be, attempting any "end-run." It bears emphasis in this regard that that Plaintiff is trying to obtain books and records relevant to the Board's refusal of demand, that this is an entirely legitimate purpose under *White,* and that, under ***Grimes****,* the legitimacy of this attempt is not called into question by the prior derivative action in New York. Moreover, as ***Grimes*** makes pellucidly clear, Section 220 provides for the right to inspect corporate documents in the wrongful refusal scenario in spite of the fact (indeed, *because* of the fact) that litigation discovery is not allowed as to this issue. *See **Grimes** I,* 673 A.2d at 1216 n. 11; ***Grimes** II,* 724 A.2d at 565-566.

The cases relied upon by Defendant for its "fishing expedition" argument illustrate perfectly why this familiar objection has no currency in the case at bar. As noted above, *Seinfeld* concerned a Section 220

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request directed solely to allegations of corporate wrongdoing as to which the plaintiff himself admitted he had no factual support. The case did not concern wrongful refusal of a derivative demand, and, for reasons noted above, does not support dismissal of Plaintiff's request for inspection even to the extent that request seeks information concerning wrongdoing. Similarly, *City of Westland Police & Fire Ret. Sys. V. Axcelis Techs., Inc.,* 2010 WL 3157143 (Del. Aug. 13, 2010), concerned only use of Section 220 in the context of investigating corporate wrongdoing, not wrongful refusal of demand and was, moreover, decided only after a full trial of all evidence. *Weiland v. Central & South West Corporation,* 1989 WL 48740 (Del. Ch. May 9, 1989), was decided nearly a decade before ***Grimes***. Moreover, while in that case, (a) the plaintiff therein had made a derivative demand on the Board to bring claims related to managerial misconduct as uncovered in a public utility commission audit which the Board refused, (b) the plaintiff sought and was refused access to the report of the special committee which investigated the derivative demand, and (c) the plaintiff sought inspection under Section 220 in part "to determine the reason for the apparent conflict between [newspaper reports concerning the audit] and the finding of the special committee" (*id.* at * 1), nonetheless, the court based its analysis solely on whether the plaintiff had alleged credible evidence of corporate wrongdoing. *See id.* at *1-*2. Finally, *Levine v. Smith,* 591 A.2d 194 (Del. 1991), did not address a Section 220 request at all, merely whether a derivative claim based on wrongful refusal of demand should be dismissed. *See id.* at 213-15. None of these cases establish that the Retirement System's Section 220 request constitutes an improper "fishing expedition" in the circumstances present in the case at bar.

CONCLUSION

For all of the foregoing reasons set forth above, the Motion should be denied.

/s/Robert D. Goldberg

Robert D. Goldberg (No. 631)

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Madisonville, Louisiana 70447

(504) 455-1400

Dated: November 12, 2010

Footnotes

1 *See, e.g., King v. Verifone Holdings, Inc.,* 994 A.2d 354, 360 (Del. Ch. 2010) ("King's only stated purpose for examining the books and records of Verifone is to seek books and records that will help him plead a viable claim for demand excusal in the pending derivative action in Federal Court").

2 The Board's counsel cited as his only example Plaintiffs' request to view a report prepared by the Skadden law firm and shared with the Board, as well as "indices" of documents and witness interviews relied upon by Skadden. *See id.* However, Plaintiffs did not seek the actual documents reviewed by Skadden, merely *indices* of those documents, and the Skadden materials were specifically relied upon by the Board in determining to reject the demand. *See id.* Exh. E. These materials plainly were relevant to the Board's demand decision and Plaintiffs' request for them was not an improper "fishing expedition" into merits discovery.

3 The procedural history of the ***Grimes*** litigation is somewhat convoluted. Originally, **Grimes** made pre-suit demand on the Board of DSC Communications Corporation asserting that certain employment contracts with its CEO were *ultra vires* under Section 141 of the Corporations Code and must be abrogated. When the Board refused this demand, **Grimes** filed a derivative action asserting claims not only under Section 141, but also for waste, excessive compensation, and breach of the duty of care. *See **Grimes** I,* 673 A.2d at 1210-12. In opposition to DSC's motion to dismiss under Rule 23.1, **Grimes** argued that demand was wrongfully refused as to the Section 141 claim and excused as to the other claims given the Board's refusal of demand. *See id.* at 1210, 1220. On the latter point, both the Chancery Court (Allen, C.) and the Supreme Court disagreed, holding that by making demand concerning the employment contracts, **Grimes** had conceded the need for demand as to all legal claims arising from the contracts and thus, had waived his right to allege that demand was excused as those claims. *See id.* at 1215, 1219-20. *See also **Grimes** II,* 724 A.2d at 564. In affirming, the Supreme Court noted that **Grimes** was not barred from making another demand on the Board as to those claims for which he had not originally made a pre-suit demand. *See id.* at 1210. *See also **Grimes** II,* 724 A.2d at 564.

Despite the convoluted procedural history of ***Grimes**,* the decisions in that case support the proposition that a plaintiff is entitled under Section 220 to books and records concerning a corporate Board's rejection of a demand to bring claims which previously had been the subject of litigation and had been dismissed on the grounds that pre-suit demand to bring those claims was not excused. *See* Stephen A. Radin, *The New Stage of Corporate Governance Litigation: Section 220 Demands--Reprise,* 28 Cardozo L. Rev. 1287, 1342 (2006) ("Where a shareholder seeks to institute a shareholder derivative action, Section 220 provides a possible method of securing facts required to overcome the shareholder's burden--a prerequisite without which the shareholder lacks standing to commence a derivative action--of alleging "either that the board wrongfully refused the plaintiff's pre-suit demand to initiate the suit or, if no demand was made, that such a demand would be a futile gesture and is therefore excused.") (quoting *White v. Panic,* 783 A.2d 543,550 (Del. 2001) (other citations and quotation marks omitted). *See also id.* at 1341-43 (discussing ***Grimes***).

4 The Board requested, and Plaintiff granted, this extension.

5 *Cf London v. Tyrrell,* C.A. No. 3321-CC, 2010 WL 877528, at *17 (Del. Ch. Mar. 11, 2010) (in determining whether special litigation committee acted on a reasonable basis and in good faith, the court *examined committee report at length* to determine whether the committee, *inter alia,* had: *investigated all theories* of recovery identified by plaintiffs, *explored all relevant facts* and sources of information that bore on the allegations, *consulted independent sources of facts* rather than accepting a defendant's accounts of the facts, and showed whether it *correctly understood the law* applicable to the case).

6 Defendant, early in its Motion, emphasizes the length of time--"nearly two years"--that elapsed between the filing of the original derivative action in New York and the making of the Section 220 request. This, of course, disregards that the delay has been for reasons entirely outside of Plaintiff's control, including the New York court's time to consider and rule on the defendants' motion to dismiss for failure to plead demand excusal, and

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the Morgan Board's own eight-month-long consideration of Plaintiff's demand. In all events, Defendant later expressly disavows any reliance on the length of time as a factor supporting dismissal. *See* Motion at 10 n. 4.

7 The New York Action has been dismissed for failure to make pre-suit demand. Plaintiff's arguments concerning the excusal of the need for such demand were rejected by Judge Hellerstein, and this is *res judicata* between plaintiffs and defendants therein. That Judge Hellerstein retained jurisdiction over the case does not change the nature of these facts; jurisdiction has been retained solely to toll the running of the statute of limitations in the event Plaintiff decided to make demand on the Board and, if that were done and demand was refused, then decided to file a new derivative action premised on wrongful refusal of demand. *See* Compl. Exh. B at 7-9 (oral argument discussing statute of limitation concerns).

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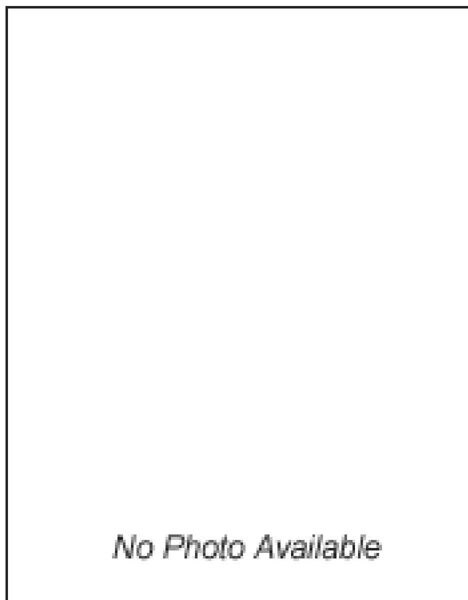

Contact Information

Donald Grimes
Bakersfield CA

Phone: (805) 399-3446

Title:
Aviation

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2003 WL 26080353 (N.Y.Sup.) (Verdict and Settlement Summary)

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WEST'S JURY VERDICTS - NEW YORK REPORTS

Defense Verdict for Lloyd MVA

Supreme Court, Ninth Judicial District, Dutchess County, New York.

Riggins v. **Grimes**

Type of Case:
Vehicle Negligence • Motor Vehicle v. Motor Vehicle

Vehicle Negligence • Permissive Use

Vicarious Liability

Specific Liability: Negligent driver collided with another vehicle

General Injury: Unspecified personal injuries

Jurisdiction:
State: New York
County: Dutchess

Related Court Documents:
Plaintiff's complaint: 2000 WL 35907365

Judgment: 2003 WL 26075113

Case Name: Assonia D. Riggins v. Eileen T. **Grimes** and Roy T. **Grimes**

Docket/File Number: 4609/2000

Verdict: Defendants, $0

Verdict Range: $0

Verdict Date: Jan. 10, 2003

Judge: Thomas J. Dolan
Attorneys:
Plaintiff: **Donald** D. Brown, Spiegel, Brown, Fichera & Acard, Poughkeepsie, N.Y.
Defendant: Michael J. Cozza, Wilson, Bave, Conboy, Cozza & Couzens, White Plains, N.Y.

Trial Type: Jury
Breakdown of Award:
$0

Summary of Facts:
Assonia Riggins was driving on North Chodikee Lake Rd., near its intersection with Route 299, Lloyd, N.Y. Aug. 31, 2000. A vehicle owned by Roy **Grimes** and driven by Eileen **Grimes** collided with Riggins.

Riggins claimed she sustained injuries as a result of the collision.

Riggins sued Roy and Eileen **Grimes** in the New York Supreme Court for Dutchess County, alleging negligence. The plaintiff sought monetary damages.

A jury before Judge Thomas J. Dolan returned a verdict for the defendants Jan. 10, 2003.

Judgment was entered against the plaintiff Feb. 14.

Court: Supreme Court, Ninth Judicial District, Dutchess County, New York.

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2019 West Virginia Laws H.B. 2831 (West's No. 208)

WEST VIRGINIA 2019 SESSION LAWS

2019 REGULAR SESSION

Additions and deletions are not identified in this document.
Vetoes are indicated by ~~Text~~ ;
stricken material by ~~**Text**~~ .

H.B. No. 2831

West's No. 208
STATE—CLAIMS—WARRANTS FOR PAYMENT OF MONEY

AN ACT finding and declaring certain claims against the state and its agencies to be moral obligations of the state; and directing the Auditor to issue warrants for the payment thereof.

Be it enacted by the Legislature of West Virginia:

§ 1. Finding and declaring certain claims against the Department of Administration; Department of Administration, Office of Technology; Enterprise Resource Planning Board; Department of Environmental Protection; Department of Health and Human Resources; Department of Health and Human Resources, Bureau for Behavioral Health and Health Facilities; Department of Health and Human Resources, Bureau for Public Health; Department of Health and Human Resources, Office of Chief Medical Examiner; Department of Health and Human Resources, Office of Laboratory Services; Department of Military Affairs & Public Safety, Division of Corrections and Rehabilitation; Department of Military Affairs & Public Safety, Division of Corrections and Rehabilitation, Regional Jail Authority; Department of Military Affairs & Public Safety, Regional Jail and Correctional Facility Authority; Secretary of State; Department of Transportation, Division of Highways; Department of Transportation, Division of Motor Vehicles; and Department of Veterans Assistance to be moral obligations of the state and directing payment thereof.

The Legislature has considered the findings of fact and recommendations reported to it by the Legislative Claims Commission concerning various claims against the state and agencies thereof and in respect to each of the following claims, the Legislature adopts those findings of fact as its own and in respect of the claims herein, the Legislature has independently made findings of fact and determinations of award and hereby declares it to be the moral obligation of the state to pay each such claim in the amount specified below and directs the Auditor to issue warrants for the payment thereof out of any fund appropriated and available for the purpose.

(a) *Claim against the Department of Administration:*

(TO BE PAID FROM SPECIAL REVENUE FUND)

WV Association of Rehabilitation Facilities, Inc.$2,172.78..

(b) *Claims against the Department of Administration, Office of Technology:*

(TO BE PAID FROM SPECIAL REVENUE FUND)

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(1) Ricoh USA$23,640.96..

(2) Ricoh USA$92,727.00..

(3) Verizon Business$28,160.00..

(4) Verizon Business$56,780.00..

(c) *Claim against the Enterprise Resource Planning Board:*

(TO BE PAID FROM SPECIAL REVENUE FUND)

WV Association of Rehabilitation Facilities, Inc.$2,492.25...

(d) *Claim against the Department of Environmental Protection:*

(TO BE PAID FROM SPECIAL REVENUE FUND)

Potesta & Associates Inc.$29,500.00...

(e) *Claim against the Department of Health & Human Resources:*

(TO BE PAID FROM GENERAL REVENUE FUND)

National Medical Services, Inc.$103,440.66...

(f) *Claim against the Department of Health & Human Resources, Bureau for Behavioral Health & Health Facilities:*

(TO BE PAID FROM GENERAL REVENUE FUND)

First Databank Inc.$23,235.00...

(g) *Claims against the Department of Health & Human Resources, Bureau for Public Health:*

(TO BE PAID FROM GENERAL REVENUE FUND)

(1) GlaxoSmithKline Pharmaceuticals$43,290.00..

(2) Sanofi Pasteur Inc.$158,386.32...

(3) Social Solutions Global, Inc.$27,445.50...

(h) *Claims against the Department of Health and Human Resources, Office of Chief Medical Examiner:*

(TO BE PAID FROM GENERAL REVENUE FUND)

Microgenics Corporation$6,167.00...

(i) *Claims against the Department of Health and Human Resources, Office of Laboratory Services:*

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(TO BE PAID FROM GENERAL REVENUE FUND)

Pitney Bowes Inc.$11,969.46..

(j) *Claims against the Department of Military Affairs & Public Safety, Division of Corrections and Rehabilitation:*

(TO BE PAID FROM GENERAL REVENUE FUND)

(1) Wendell K. Ash$200.00..

(2) Wendell K. Ash$52.95..

(3) Wendell K. Ash$33.49..

(4) Gary Baker$25.00..

(5) Gary R. Baker$1,674.00..

(6) Foster Bowen$856.32..

(7) Anthony William Cartagena$884.75..

(8) Thomas G. Carter Jr.$120.00..

(9) Bannar C. Catlett$793.00..

(10) Jonathan Charles Cochran$240.00..

(11) Ronald L. Cosner$25.00..

(12) Crosier's Sanitary Service Inc.$19,044.50...

(13) Keith Dement$158.35..

(14) David Lawrence Dixon$300.00..

(15) Earthtec Environmental Services LLC.$7,500.00...

(16) Deshaun Evans$491.27..

(17) Kevin S. Ford$106.38..

(18) Jason Douglas Freeman$319.77..

(19) Terrance Hamrick$220.60..

(20) Ferlin Heavener$86.79..

(21) Douglas C. Jackson Jr.$554.10..

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(22) William Macri$3,200.00...

(23) Brian Markley$50.00...

(24) Mark McAtee$70.60...

(25) Marlin McClain$42.50..

(26) Marlin McClain$730.00..

(27) Brent Levi Victor McGilton$90.30..

(28) Justin McKenzie$99.17..

(29) Letcher McKinney II$527.12...

(30) Rodger D. Mitchell$14.00..

(31) Garland Murray$275.00...

(32) Jason Perry$570.00..

(33) Matthew Reed$30.00...

(34) Matthew D. Reed$44.04..

(35) Martin Riley Robinson$659.64..

(36) Christopher Roof$41.50...

(37) Christopher Roof$187.50...

(38) Brian John Stone$1,179.47..

(39) Charles Taylor$40.00...

(40) Jeffrey Taylor$130.00..

(41) Arthur Thornton$30.44..

(42) Raymond S. Wallace$223.21...

(43) Phillip A. Ward$511.27...

(44) Joshua Webster$222.60...

(45) Joshua Webster$415.00...

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(46) Wilson Restoration Inc.$29,000.00..

(47) John Wilson$130.00..

(48) Roy Lee Wisotzkey$832.81..

(49) Brian K. Woodson$150.00..

(50) Larry Wooten$60.47..

(51) Edwin Lee Wright$763.00..

(52) William B. Wriston$54.74..

(53) Henry Keith Wykle$252.90..

(k) *Claims against the Department of Military Affairs & Public Safety, Division of Corrections and Rehabilitation, Regional Jail Authority:*

(TO BE PAID FROM SPECIAL REVENUE FUND)

(1) Jason Ray Blankenship$441.98..

(2) Justin T. Mitchell$784.00..

(l) *Claims against the Department of Military Affairs & Public Safety, Regional Jail and Correctional Facility Authority:*

(TO BE PAID FROM SPECIAL REVENUE FUND)

(1) Zachary Taylor Blake$88.74..

(2) James R. Davis$679.94..

(3) Clairesse Felipe$1,097.92..

(4) Meronica Harrison$600.00..

(5) Jeffrey Allen Hazlett$96.28..

(6) Hunter C. Morela$267.00..

(7) Russell William Oliver$600.00..

(8) Troy Peace$1,319.00..

(9) Mark T. Radcliffe and Angela L. Radcliffe$35.32..

(10) Sharnjeet Singh$7.00..

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(11) Basim A. Talouzi$150.00..

(12) Joshua Thornhill$131.87..

(13) Dionne Townsend$119.60..

(14) Cynthia Van Dyne and Justin Stefanko$31.79..

(15) Mark W. Van Meter$300.00..

(16) Wendy Watson and Joseph M. Watson$19.27..

(m) *Claim against the Secretary of State:*

(TO BE PAID FROM GENERAL REVENUE “ REAPPROPRIATED FUNDS)

West Virginia Interactive, LLC$106,378.00...

(n) *Claims against Department of Transportation, Division of Highways:*

(TO BE PAID FROM STATE ROAD FUND)

(1) Emma Abbott$500.00..

(2) Mohamed Aboelmagd$800.00..

(3) Christopher Abraham$212.35..

(4) Benjamin C. Adams$2,000.00..

(5) Clifton L. Adams$500.00..

(6) Karen S. Adams$399.06..

(7) Karen S. Adams$183.87..

(8) Roma J. Adams$1,453.40..

(9) Matthew Adkins and Annie Adkins$899.25..

(10) Shane Adkins and Sarah Elizabeth Adkins$186.18..

(11) John R. Akers$231.64..

(12) Paul F. Alderman and Betty A. Alderman$331.52..

(13) Artvetta Alexander and Marcus K. Patterson$79.22..

(14) Joseph Altizer$500.00..

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(15) Michael Alvarez$109.50..

(16) Deborah A. Aman-Paugh$151.50..

(17) Timothy A. Amick$119.99...

(18) Howard D. Anderson and Marquita J. Anderson$323.90...

(19) Kathy J. Anderson$348.47...

(20) Thomas Andreas$250.00..

(21) Ivan Antill Jr.$250.00...

(22) David W. Apts.$1,000.00...

(23) Jason L. Arthur and Brandy Arthur$309.52...

(24) Joel Kevin Arthur and Sonya A. Arthur$294.43...

(25) Charles Arthurs$250.00..

(26) Brian Scott Asbury$79.72...

(27) Richard Asherman$17,152.00..

(28) Tracey Assi$500.00..

(29) **Donald** E. Austin$250.00..

(30) Jasmine Austin$4,567.39...

(31) Toni Bailey$500.00...

(32) Montana L. Bailey and Jeffery T. Bailey II$500.00...

(33) Sonia Bailey-Gibson and William B. Gibson Jr.$210.20...

(34) Jennifer R. Baldwin and Brian D. Baldwin$225.07..

(35) John D. Ballard and Tammy R. Ballard$1,000.00..

(36) Greg Bamberger$132.50...

(37) John Barkley and Mary C. Barkley$497.35...

(38) Samantha Barlow, Brittany M. Squires and William D. Squires$500.00.....................................

(39) Nathan Barnes and Jessica Barnes$276.24..

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(40) Keirsten Barnett$500.00...

(41) Mary Lou Barnett and Timothy J. Barnett$278.20..

(42) Kelly A. Barrett and Michael J. Barrett$1,000.00...

(43) Mishae Bartoe$358.45...

(44) Nadine Bateman$500.00...

(45) Michelle Beatty and Donna Beatty$125.02...

(46) Bonnie Beaver and Robert Beaver$352.18...

(47) Edward Beech and Barbara Beech$500.00..

(48) Ramona Beer$286.11...

(49) Thomas Beets$79.97..

(50) Loretta Belanger and Larry Belanger$500.00..

(51) Sabrina Belcher, Rena Lawless and Randall Lawless$3,977.17...

(52) Tammy Belcher$500.00...

(53) Joy Bell$500.00..

(54) Steve's Auto Sales and Steven Bellman$815.73...

(55) Robert E. Bennett and Loue Bennett$201.53...

(56) Jeremy Benson$782.18..

(57) Sarah Bentley and Michael Bentley$350.73...

(58) Virgil Birkhimer$138.50..

(59) Larry J. Bise$275.60..

(60) Tammy L. Black$419.57..

(61) Patsy Blackburn and Mark D. Blackburn$500.00...

(62) Andrea Blackshire$500.00..

(63) Elizabeth Blackwell and Brett Blackwell$688.45...

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(64) Richard Blake$473.87...

(65) Ashley Bennett Blankenship and Colonel R. Blankenship$600.00..

(66) Sue A. Blankenship and Clayton L. Blankenship$628.58...

(67) Terry L. Bledsoe$463.22...

(68) Marra O. Bodkin$250.00...

(69) Barry C. Boggs and Deborah L. Boggs$1,000.00...

(70) Robert Lee Bolton III$53.50...

(71) Jerry L. Bolyard and Susan J. Bolyard$250.00..

(72) Larry R. Bonasso$370.87...

(73) Jeffery Bonaventura$339.20...

(74) Brenda Dianne Bonnett and Don Bonnett$500.00...

(75) Clement A. Bossie.$415.52...

(76) David E. Bowles$208.27..

(77) Ralph T. Bowles and Lisa E. Bowles$713.31...

(78) Haley N. Bowman$466.42..

(79) Franklin Boyce and Kristen Boyce$500.00...

(80) Mark D. Boyce$1,000.00...

(81) Deborah L. Boyd$233.20...

(82) Sheila J. Braddock$100.00...

(83) Gerald Brady Jr.$750.00..

(84) Vernon J. Braham and Shirley Braham$250.00..

(85) Jeannine L. Branch and Dallas Branch$500.00..

(86) Ralph Brandon and Tammy Brandon$250.00...

(87) Ralph Brandon and Tammy Brandon$250.00...

(88) William Brewer and April Brewer$500.00..

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(89) Sumner D. Brody$206.70..

(90) Homer C. Brooks and Cynthia Brooks$250.00...

(91) Aaron L. Brown$500.00..

(92) Brandi Lynn Brown$459.54..

(93) Chad Brown and Clara Brown$250.00...

(94) Dale A. Brown and Regina L. Brown$500.00..

(95) Danielle R. Brown$430.09...

(96) James Brown$500.00...

(97) Joshua O'Neal Brown and Amber Brown$281.64...

(98) Kellie Brown$1,000.00..

(99) Nicholas Brown$654.74...

(100) Peggy L. Brown$279.23...

(101) Shannon Brown$500.00..

(102) Jerry Brown and Kathy Brown, his wife$30,000.00...

(103) Jacqueline Ann Browning$500.00...

(104) John Nicholas Browning$500.00..

(105) Rhonda L. Bruffy$206.70...

(106) Diana Brunson and Shayne Brunson$219.34...

(107) Carla Buford$370.92...

(108) Chuck Bumpus$209.88..

(109) James Bunner$250.00..

(110) Lew R. Burdette and Joyce L. Burdette.$500.00..

(111) Kayla Burnem$347.31..

(112) Amanda R. Butcher and David Butcher$95.23...

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(113) Vickie Cadle$264.96..

(114) Brad Callahan and Brittani Callahan$267.09..

(115) Robert D. Calvert Jr. and Darla J. Calvert$500.00...

(116) Gary Campbell Jr. and Trista Campbell$291.50...

(117) Phillip J. Campbell and Kristyn Campbell$222.18..

(118) Dominic Campeti, Janet Campeti and Joseph Campeti$133.03..

(119) Ryan C. Campione$93.28...

(120) Sean T. Canterbury and Lea A. Canterbury$284.95..

(121) Michael P. Cappel and H. Roy Cappel$125.23..

(122) Gregory A. Carpenter$193.64..

(123) Carolyn Carrico and Suzanne Carrico$606.00..

(124) Adelle J. Carson$449.77..

(125) Christopher Castillo$500.00...

(126) Michael J. Cestaric$250.00..

(127) Mark Chambers$515.73...

(128) Charles Chambliss$68.90...

(129) Daniel Chandler Jr. and Alex Chandler$500.00...

(130) Melissa Chandler$250.00...

(131) Tiffany B. Chandler$800.99...

(132) Janice E. Channel$75.60..

(133) Carolyn Channell$300.00...

(134) Judy A. Chappell and Steven Chappell$487.55..

(135) Michael A. Chauvet.$320.14..

(136) Justin Cherry$500.00..

(137) Jonathan Childers$500.00..

(138) Scott Childers$500.00...

(139) Christian Life Center$8,500.00...

(140) Mary Clark and Tonya Clark$255.41..

(141) Homer Lee Clark Jr.$1,000.00...

(142) Susan Clary and Luther Clary$150.00..

(143) Timothy L. Clemens$250.00..

(144) Arch Cline$265.50..

(145) Roger Cochran Sr.$50.00...

(146) Christian Lee Coe and Dennis Coe$381.51..

(147) Dennis L. Coe and Renee Coe$500.00..

(148) Melissa Coffman$252.28..

(149) Jeffrey W. Cole$500.00...

(150) Richard K. Cole and Mary J. Cole$500.00...

(151) Kimberly Colebank$500.00...

(152) Whitney Colvin$250.00...

(153) Dusty Conrad and Laraya Jean Conrad$250.00..

(154) Janet S. Conrad and Danny Conrad$330.00..

(155) Jennifer L. Conrad and Charles Conrad$117.15..

(156) Logan T. Conrad$230.00..

(157) James D. Cook and Beth Cook$500.00...

(158) Timmy E. Cook and Suzette Cook$786.78...

(159) Kari Cooper$500.00...

(160) Shayne M. Cooper$12,500.00..

(161) Danny Lee Cornell$1,000.00...

(162) Frank Corona$218.30..

(163) Michael R. Costello$389.91...

(164) James Matthew Coulter$250.00...

(165) Earnest Covington III$363.90...

(166) Donna K. Cramer$500.00...

(167) Linda Crane$352.76..

(168) Harry E. Craven$107.16..

(169) Darby K. Crews$151.00..

(170) David L. Cross and Brenda Sue Cross$215.71...

(171) Tonya L. Cross$454.26..

(172) Chantelle Cumpston$481.79...

(173) Timothy Cunningham$100.00..

(174) **Donald** Joseph Currier$1,295,332.00...

(175) Orville Cutright and Georgia O. Cutright$200.00..

(176) Jeannie Dailey$500.00...

(177) Aaron W. Dalton$491.66...

(178) James S. Dalton$277.58..

(179) Tiffany Dalton$500.00...

(180) **Donald** A. Dare$500.00..

(181) Anthony Davis and Sherry Davis$500.00..

(182) Linda Davis$500.00..

(183) Lindsey Dawson, Dennis Dawson II and Karilynne S. Pryor$95.23.....................................

(184) Jacalyn S. Day and Michael D. Day$132.50..

(185) William R. Dean and Cynthia Y. Dean$500.00..

(186) Cheryl L. Deaner$500.00...

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(659) James L. Snider$161.60..

(660) Joseph Snopps and Jessica Snopps$373.12..

(661) Frances M. Sokos and Gus M. Sokos$302.05..

(662) Frances M. Sokos and Gus M. Sokos$238.50..

(663) Joseph Somers$511.91..

(664) Kevin T. Sparks and Kelly Sparks$932.18..

(665) Steven James Spears$411.28..

(666) William Spence and Arlene Spence$83.21..

(667) Terry Sprouse and Denise Mae Sprouse$239.94..

(668) Paul Stacy and Sharon Stacy$166.00..

(669) Adam Stafford, Timothy Paul Ash and Tesa Hope Ash$90.63..

(670) Anthony B. Stake Jr.$380.00..

(671) Bonny Starkey$500.00..

(672) Nancy Stemple$500.00..

(673) James Stewart and Jill Stewart$194.74..

(674) Melissa Stewart$886.86..

(675) Kasha Stitt and Jason B. Stitt$238.22..

(676) Sarah S. Stolze$500.00...

(677) Paul C. Stout and Susan J. Stout$500.00...

(678) Thomas A. Stout and Paula J. Stout$250.00...

(679) Carl Straub Jr. and Tammy Straub$439.14...

(680) Gary Sumpter Jr.$500.00...

(681) Floyd F. Sutherland$422.18..

(682) Barbara E. Swartz$500.00..

(683) Jeri Swingle$500.00...

(684) Mary E. Sword$239.90...

(685) Barbara L. Tatterson$250.00..

(686) Marcy Taylor$354.04...

(687) Howard L. Templin$500.00..

(688) Greg Tenley and Lori Tenley$321.91..

(689) Paul J. Tepe and Inge A. Tepe$257.99...

(690) Lee Theaker$327.94...

(691) Alyssa Thibaut and Jerome Thibaut$159.00...

(692) Iva Thomas$448.40..

(693) Janet Thompson$200.76...

(694) Olivia Thompson$500.00..

(695) Eric L. Tichenor and Terri L. Tichenor$576.87..

(696) Carolyn Dianne Tincher$500.00...

(697) Lawrence Tingler Jr.$284.81...

(698) Mary A. Tinney$200.00..

(699) Damian Tofte$500.00...

(700) Brady C. Totten and Betty S. Totten$3,525.65..

(701) Daniel Trautwein and Nancy Trautwein$326.88..

(702) Ralph L. Travis and Irene Travis$500.00..

(703) Leah Marie Trent$148.19...

(704) Trimble Inc.$177,258.40...

(705) Jeffrey Allen Tucker and Christina Renee Tucker$202.30...

(706) Jerry Tucker$149.37..

(707) Joseph Tucker$315.88..

(708) Crista Turner$500.00...

(709) Debbie Vac and Dennis A. Vac$297.97...

(710) Alfred G. Valle$473.32...

(711) Constance Van Gilder and Gregory T. Van Gilder$290.00...

(712) James Vanhoose and Paula Vanhoose$628.71..

(713) Velvet L. Vaughn$258.62...

(714) Jody Veith and Robert Veith$202.35..

(715) Natalie D. Vinton$500.00...

(716) Natalie D. Vinton$112.58...

(717) Shelby Vrescak and Julius Vrescak$159.98...

(718) Aaron Wagner$95.30...

(719) Sandra S. Walker and Gary L. Walker$500.00..

(720) Ryan S. Walther$362.33..

(721) Sarah Marie Ware$252.28...

(722) Roy L. Watkins and Anita J. Watkins$1,000.00...

(723) Juanita G. Watts and David W. Watts$171.20..

(724) Monica Renee Watts$552,500.00...

(725) Deborah A. Weaver and Mark A. Weaver$365.70..

(726) Pamela Weaver and Bruce Weaver$1,000.00..

(727) Tyler A. Webb$250.00..

(728) Craig A. Welch$250.00..

(729) Ian Welch and Krystal Wicker$573.05..

(730) Lacy L. Welch$1,000.00..

(731) Lori A. Wells$342.57..

(732) Bartlett J. Wheeler$124.04..

(733) Danny W. Wheeler and Tenyah N. Wheeler$404.85..

(734) Heather Whipkey and Mark Whipkey$419.60..

(735) Joanna White$168.54..

(736) Mark S. White and Pamela C. White$392.55..

(737) Timothy W. White and Randi L. White$500.00..

(738) Vincen W. White and Bonnie White$500.00..

(739) Brett L. Whiting and Sarah J. Whiting$455.04..

(740) Bruce S. Whoolery and Rose Marie Whoolery$129.27..

(741) David R. Widdifield$617.02..

(742) Charles Wiener and Nancy Ohrenstein$500.00..

(743) Sean Wightman and Rodney Wightman$119.50..

(744) Lee Wiley$1,000.00..

(745) Serena Wilkerson$532.49..

(746) Nathan F. Wilkinson and Julie R. Wilkinson$445.14..

(747) Joyce Williams$495.54..

(748) Roger R. Williams and Kandy K. McCauley$151.58..

(749) April F. Williams-Early$299.60..

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(750) Michael Williamson and McKenna Williamson$92.88..

(751) Susan R. Wilson and John Wilson$332.85..

(752) Timothy Wilson and Michelle Wilson$112.99..

(753) Kipp Wimmer$389.02..

(754) Matthew J. Winans$948.64..

(755) James S. Wise$500.00..

(756) Pauletta Witt$500.00..

(757) Ahmed Witten$281.98..

(758) Amy M. Wolfe and Andrew J. Wolfe$133.75..

(759) Peggy J. Wolfe$500.00..

(760) Ronald P. Wood$219.31..

(761) Nancy J. Wooddell$279.42..

(762) Gary Workman$454.00..

(763) Eddie Beryl Workman and Laura Parker$1,200.00..

(764) Barbara Wright$449.40..

(765) Brian F. Wright and Amanda M. Wright$236.47..

(766) Jacob Turner Wright$500.00..

(767) Kyle P. Wyjad and Alyssa N. Wyjad$253.98..

(768) Michele Yates$1,380.00..

(769) Allen Yeager$250.00..

(770) Carolyn Young and James Young$275.51..

(771) Daniel R. Young$239.53..

(772) Ronald W. Young$180.91..

(773) Luther M. Young Jr.$222.58..

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(o) *Claim against the Department of Transportation, Division of Motor Vehicles:*

(TO BE PAID FROM statE road FUND)

Paul Ritchey and Dianna Ritchey$180.00..

(p) *Claims against the Department of Veterans Assistance:*

(TO BE PAID FROM GENERAL REVENUE FUND)

(1) Carl E. Short$9,616.56...

(2) WV Association of Rehabilitation Facilities, Inc.$2,148.62..

The Legislature finds that the above moral obligations and the appropriations made in satisfaction thereof shall be the full compensation for all claimants and that prior to the payments to any claimant provided in this bill, the Legislative Claims Commission shall receive a release from said claimant releasing any and all claims for moral obligations arising from the matters considered by the Legislature in the finding of the moral obligations and the making of the appropriations for said claimant. The Legislative Claims Commission shall deliver all releases obtained from claimants to the department against which the claim was allowed.

Approved March 26, 2019.
Passed March 8, 2019; in effect from passage.

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2018 IN REG TEXT 467756 (NS)

Indiana Regulation Text - Netscan
326 IAC 2-1.1-6; 326 IAC 2-7-13, 17; 326 IAC 2-8-13, 18; 326 IAC 2-12-1
Other Notices
April 18, 2018
Air Pollution Control Division

Legal Notice Provisions for Permits Issued under the New Source Review (NSR) and Title V Permit Programs

The Indiana Department of Environmental Management (IDEM) is soliciting public comment on amendments to rules at 326 IAC 2-1.1-6, 326 IAC 2-7-13, 326 IAC 2-7-17, 326 IAC 2-8-13, 326 IAC 2-8-18, and 326 IAC 2-12-1, concerning legal notice provisions for permits issued under the New Source Review (NSR) and Title V permit programs. IDEM seeks comment on the affected citations listed and any other provisions of Title 326 that may be affected by this rulemaking.

326 IAC 2-1.1-6

326 IAC 2-1.1-6

326 IAC 2-7-13

326 IAC 2-7-13

326 IAC 2-7-17

326 IAC 2-7-17

326 IAC 2-8-13

326 IAC 2-8-13

326 IAC 2-8-18

326 IAC 2-8-18

326 IAC 2-12-1

326 IAC 2-12-1

TITLE 326 AIR POLLUTION CONTROL DIVISION

SECOND NOTICE OF COMMENT PERIOD

LSA Document #17-395

ELECTRONIC NOTICE FOR AIR PERMITS

PURPOSE OF NOTICE

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The Indiana Department of Environmental Management (IDEM) is soliciting public comment on amendments to rules at 326 IAC 2-1.1-6, 326 IAC 2-7-13, 326 IAC 2-7-17, 326 IAC 2-8-13, 326 IAC 2-8-18, and 326 IAC 2-12-1, concerning legal notice provisions for permits issued under the New Source Review (NSR) and Title V permit programs. IDEM seeks comment on the affected citations listed and any other provisions of Title 326 that may be affected by this rulemaking.

HISTORY

First Notice of Comment Period: September 6, 2017, Indiana Register (DIN: 20170906-IR-326170395FNA).

CITATIONS AFFECTED: 326 IAC 2-1.1-6; 326 IAC 2-7-13; 326 IAC 2-7-17; 326 IAC 2-8-13; 326 IAC 2-8-18; 326 IAC 2-12-1.

AUTHORITY: IC 13-14-8; IC 13-17-3-1; IC 13-17-3-4.

SUBJECT MATTER AND BASIC PURPOSE OF RULEMAKING

Basic Purpose and Background

On October 18, 2016, the United States Environmental Protection Agency (U.S. EPA) published a final rule in the Federal Register (81 FR 71613) that became effective on November 17, 2016, revising the public notice provisions for the NSR and Title V permit programs. The final rule revised the requirement to provide public notice of certain draft air permits through publication in a newspaper. Instead, the final rule requires the publication of an electronic notice for draft permits and actions issued by U.S. EPA or by permitting authorities implementing U.S. EPA's federal permitting rules and allows for electronic notice as an option for actions by permitting authorities implementing U.S. EPA-approved programs.

Indiana implements a U.S. EPA-approved program that meets the requirements of 40 CFR 51 and 40 CFR 70. The rule allows states with an approved program the option of adopting either electronic notice or newspaper publication as the primary method of public notice. The final rule states that whichever method the permitting authority chooses to adopt must be indicated to the public as the consistent noticing method used, and must provide reasonable access to other materials that support the permit decision, including the draft permit. The final rule does not prevent permitting authorities from supplementing electronic notice with a newspaper notice or additional means of notification to the public.

Historically, IDEM has relied on local newspapers to provide public notice for permit and other agency actions. However, as newspaper circulation continues to decline, smaller newspapers are going out of business while others are being bought by larger corporations, making printed newspaper advertisements less effective in providing widespread public notice of permit actions. The average weekday circulation of both print and digital newspapers fell seven percent in 2015, which was the greatest decline experienced by the industry since 2010.[**1] More recently, ten Indiana newspapers were bought by an out-of-state company, which has led to hurdles and delays regarding the publication of some permit actions. In some cases, publications have been delayed up to two weeks, which causes further delays issuing permits and can negatively impact businesses seeking the permit. In addition, public notices in newspapers can only reach the individuals that subscribe to the specific newspaper where the notice is published and that happened to read that issue, while an electronic notice is available to anyone for free and remains on the webpage for an extended period of time.

The Internet has become the predominant medium by which the public obtains information, and usage continues to spread throughout all demographic groups. A report by the Department of Commerce notes that as of July 2015, 77 percent of all adults and children above the age of three years old in Indiana use the Internet regularly. [**2] During the last decade, the federal government and many state governments have increased their use of the Internet and information technology to bring about improvements in government operations and customer service. As a result, agencies and permitting authorities are utilizing electronic notices as a more convenient, cost-effective, and expedient method of communicating important agency notices and actions to the public.

In this rulemaking, IDEM is proposing to adopt electronic notices as the primary and consistent means for communicating air permit notices to the public. Several of IDEM's program areas already publish public notices electronically on the department webpage located at http://www.in.gov/idem/5474.htm. IDEM's air permitting program has a searchable online database for the public that links directly to the public notices and is found at http://www.in.gov/ai/appfiles/idem-caats/. IDEM anticipates that converting to electronic notices as the primary method of public notice will enable permitting authorities to communicate permitting and other affected actions to the public more quickly and efficiently.

For individuals that do not have convenient computer or Internet access, they can request to receive notice through the mail about air quality permit actions in their area or related to specific sources. Individuals on this list receive a mailed notice any time a permit action in their area goes to public notice, and again when the permit is issued. The public can choose to have their names added for permit actions in a specific county or multiple counties, or for permit actions pertaining to just one source or multiple sources. Additionally, individuals may subscribe to the agency email notification system to receive email notifications for public notices based on geographic region, by visiting http://www.in.gov/idem/5474.htm.

Comments received by U.S. EPA from permitting authorities already implementing electronic notices found it has been effective and convenient in communicating permitting activity to the public and enables broader and faster dissemination of information compared to newspaper notices. Similarly, IDEM anticipates that electronic notices will expand public access to permit-related documents. Transitioning from printed newspaper notices to electronic notices will also provide a cost savings for the department of approximately $17,000 per year.

IDEM seeks comment on the affected citations listed, including suggestions for specific language, any other provisions of Title 326 that may be affected by this rulemaking, and alternative ways to achieve the purpose of the rulemaking.

IC 13-14-9-4 Identification of Restrictions and Requirements Not Imposed under Federal Law

No element of the draft rule imposes either a restriction or a requirement on persons to whom the draft rule applies that is not imposed under federal law.

Potential Fiscal Impact

Transitioning to electronic notices for permit actions will provide a cost savings to the department of approximately $17,000 per year.

Public Participation and Work Group Information

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At this time, no work group is planned for the rulemaking. If you feel that a work group or other informal discussion on the rule is appropriate, please contact Keelyn Walsh, Rules Development Branch, Office of Legal Counsel at (317) 232-8229 or (800) 451-6027 (in Indiana).

SUMMARY/RESPONSE TO COMMENTS FROM THE FIRST COMMENT PERIOD

IDEM requested public comment from September 6, 2017, through October 6, 2017, on alternative ways to achieve the purpose of the rule and suggestions for the development of draft rule language. IDEM received comments from the following parties by the comment period deadline:

Anonymous (A1) Anonymous (A2) Anonymous (A3)

Anonymous (A4) Anonymous (A5) Anonymous (A6)

Anonymous (A7) Anonymous (A8) Anonymous (A9)

Anonymous (A10) Anonymous (A11) Anonymous (A12)

Anonymous (A13) Anonymous (A14) Anonymous (A15)

Anonymous (A16) Anonymous (A17) Anonymous (A18)

A. French (AF) A. Zamudio (AZ) Abigail Surles (ASu)

Alan Mcpherson (AM) Alexandra Miles-Lasseter (AML) Alison Leslie (AL)

Alison Stankrauff (ASta) Allison Strang (ASt) Amanda Rodenberg (AR)

Amanda Shepherd (ASh) Amber Angel (AA) Amy Hammer (AHa)

Amy Odean (AO) Andrea Ebbert Dixon (AED) Andrea Holwager (AH)

Angie Jones (AJ) Angie Sieb (AS) Anita Golba (AG)

Anita Gyojin Cherlin (AGC) Anitra Potts (AP) Ann Baas (AB)

Ann Frutkin (AFru) Ann Trierweiler (AT) Anna Pratt (APr)

Anne Fraker (AFr) Annie C. (AC) Antonia Mattthew (AMa)

Ari Hodes (AHo) Ashley Smith (ASm) Ashley Williams (AW)

Austin Williams (AWi) Babulal Banthia (BBa) Barb Horban (BHo)

Barbara and Philip Pitzer (BPP) Barbara Bell (BBe) Barbara Cox (BC)

Barbara Gelder (BG) Barbara Hargrove (BHarg) Barbara Howard (BHow)

Barbara King (BK) Barbara Maugeri (BM) Bejamin Wiebe (BW)

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Brenda Brannigan (BBr) Brian Hardwick (BHar) Bruce Outcalt (BO)

Bruce Simmons (BSi) Camille Roberts Krick (CRK) Camille Thorns (CT)

Candie Glisson (CG) Carol Gray (CGa) Carol Hatfield (CH)

Carol McDowell (CMD) Carol Montgomery (CMo) Caroline Lipp (CLi)

Carolyn Beck (CB) Carolyn De Voe (CDV) Caron Leader (CL)

Cassie Majetic (CMa) Cathy Roemer (CR) Cecilia Mora (CM)

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Cindy Peters (CP) Colby Jay Holmes (CJH) Colleen Cleary (CCl)

Connie Everts (CE) Cynthia Wuerth (CW) D. L. Rivers (DLR)

D. R. Mckee (DRM) Dale Biberstein (DBi) Dale Platt (DPl)

Daneta Payne (DP) Darilynn Mccoy (DMc) Darrell La Lone (DLL)

Darren Lyle (DLy) Daryl Emowrey (DEm) Dave Ellis (DEl)

Dave Taylor (DT) David Gotshall (DG) David James (DJam)

David Jester (DJ) David Kinkaid (DK) David Storey (DSt)

Dawn Nye (DN) Dayna Wick-Carlson (DWC) Dean Hensel (DHe)

Deana Jacobs (DJa) Deb Sitarski (DSi) Debbie Nowlin (DNo)

Debby Willette (DW) Deborah Cavanaugh (DCa) Deborah Larkin (DLa)

Deborah Pierce (DPi) Dee Evans-Hein (DEH) Dee Moore (DM)

Deena Chambers (DC) Denise Burch (DBu) Denise Sleppy (DSl)

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Diane Hill (DH) Dinah Holtzman (DHo) **Donald** Baumis (DB)

Donna Cunningham (DCu) Donna Ehret (DE) Dorothy Spencer (DSp)

Dorrie Steele (DS) Doug Reynolds (DR) Douglas Kirk (DKi)

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Ed Webb (EW) Edith Hardcastle (EH) Edward Sulicz (ESu)

Eileen Badder (EB) Elaine Declue (ED) Elizabeth Sierra (ESi)

Elizabeth Smoyer (ESm) Ellen Germaine (EG) Ellen Urbanski (EU)

Elliott Kavanaugh (EKa) Emily Griffith (EGr) Erica Salzman (ESa)

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Jeff Gruszewski (JG) Jeff Kleinlein (JKl) Jeffrey W. Miller (JWM)

Jennifer C. Rockhold (JCR) Jennifer Kinney (JKi) Jennifer Washburn (JWas)

Jesse Kirkham (JKirk) Jessica Cresseveur (JC) Jil Browne (JBr)

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John Marquis (JMar) John Newbauer (JN) John Reynolds (JR)

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Robert Buzzard (RBu) Robert Compton (RCom) Robert L. Kerby (RLK)

Robert Newman (RN) Robert Weiser (RW) Roberta Nahas (RNa)

Robin Latta (RLa) Robin Neft (RNef) Robin Young (RY)

Robyn Zapp (RZ) Robynn Merkel (RMe) Rochelle Foran (RF)

Roger Williams (RWil) Ronald Drahos (RD) Rosalind Webb (RWe)

Roxanne Hartung (RHa) Roxanne Ling (RL) Rut T. (RT)

S. Reiff (SRe) Sabine Sturm (SSt) Sally Kiebdaj (SKi)

Sam Wilson (SWi) Sandra French (SFr) Sandra Hoy (SHo)

Sara Pappas (SP) Sarah Bilek (SBi) Sarah Clevenger (SCle)

Sarah Gray (SGr) Sarah Haefner (SHa) Sarah Kopeschka (SKo)

Sarah Spelbring (SSp) Schuyler Kempton (SKe) Scott Shafer (SS)

Shaun C. Lighty (SCL) Shawn Spinney (SSpi) Shayna Burko (SB)

Shellee Klausmeier (SK) Sherry Ballard (SBa) Sierra Club (SC)

Silvia Holman (SH) Skip Lyford (SL) Stephanie Everts (SE)

Stephanie Pierce (SPi) Stephanie Scarbrough (SSc) Steve Cashdollar (SCa)

Steve Gamblin (SG) Steve Gerber (SGe) Steve Leyndyke (SLe)

Steve Mcpherson (SM) Steve Shoemaker (SSh) Steven R. Coomer (SRC)

Steven Rody (SR) Steven Wilson (SW) Sue Freas (SF)

Sue King (SKin) Sue Mcclellan (SMc) Sue Norris (SN)

Susan Barhan (SBar) Susan Hansen (SHan) Susan Kenning (SKen)

Susan Odonnell (SO) Susan Sirnic (SSi) Tamara Robbins (TR)

Tammy Fisher (TF) Tammy Swoboda (TSw) Taylor Mock (TM)

Ted Claghorn (TCl) Teresa Koschmeder (TKo) Terrance DeShone (TDS)

Terri Waywood (TWa) Thomas Hoover (THo) Thomas Klages (TK)

Timothy Gonsorek (TG) Tina Costin (TC) Tisa Gray (TGr)

Tom Hougham (TH) Tom Mee (TMe) Tom Sunlake (TS)

Toni Long (TLo) Toni Wisener (TW) Traci Morick (TMo)

Trevor Laughlin (TLa) Trudy Dunaway-Brown (TDB) Tuck Langland (TL)

Tyson Domer (TD) V. Streiff (VSt) Venita Hooper (VH)

Veronica Gabet (VG) Vicki Brown (VB) Vickie Shearer (VS)

Walter Robinson (WR) Wanda Wilkey (WW) Warren Cross (WC)

Wayne Urton (WU) Wes Milner (WM) Wesley Evans (WE)

William James (WJ) William Keys (WK) William Smith (WS)

Wilma Davison (WD)

Following is a summary of the comments received and IDEM's responses thereto:

Comment: Social media like FB should be used. Not newspapers. (A2)

Comment: Despite editorials in our local newspaper to the contrary, I believe the idea of having electronic postings versus newspaper public notices to be a good one. Our world today revolves around the internet and young people read everything online. Just as banks have found that branches are becoming less necessary because of internet banking, government needs to adjust its approach as well. The money saved along with the equal and perhaps wider reach of internet posting is an obvious next step. (CMD)

Response: IDEM agrees that trends in information dissemination have increasingly changed to more computer and internet-based sources than newspaper or other printed sources over the years. The use of social media as a news source by younger generations is also a growing trend, and one that will be even more prevalent as these generations reach adulthood. IDEM has a responsibility to keep pace with these trends in order to continue providing the best service to the public, and converting to electronic notices as the primary method of public notice will help achieve this goal.

Comment: I oppose changes on public notification regarding air pollution emissions. (A1)

Comment: Please do not stop publishing public notices in the newspaper! (HB)

Comment: Please do not change to electronic notice for IDEM air pollution permits. Printed notice continues to be necessary and expected. (MM)

Comment: I am writing to express my disapproval of the proposed plan to eliminate newspaper notices. (LD)

Comment: Printed notices in local newspapers remain an important and centralized source of public information for civic-minded Hoosiers. (TD)

Comment: Please do not stop publishing public notice ads in local newspapers. Publishing such notices only online will not serve the public well. (CR)

Comment: I strongly urge IDEM to continue to publish public notices in the applicable local newspapers. I read these notices diligently as I have property in the state and want to be informed of any potential effects to this land. (PLo)

Comment: Public notice by way of news media is still appropriate for making communities aware of projects. Postings only on your website are not sufficient. (TR)

Comment: Please continue to publish IDEM notifications in all newspapers. (RLan)

Comment: We the people you got to be kidding me. (A18)

Comment: Very bad idea. This is very important for the public to know. "We the People" have every right to know what is going on in our community. We are tax payers also! (GBoy)

Comment: I do believe that these notifications are statutorily required to be published in the newspapers. I will be contacting my State Representative Matt Lehman about this matter of only publishing these notifications on the State website. (TCl)

Comment: As a taxpayer and lifelong resident of Indiana I do not want the elimination of public air pollution notices eliminated from being posted in public newspapers. It is important as most people do not go online or follow government websites routinely to be aware of such postings. Saving a few dollars does not justify this action of eliminating published public notices and it takes away from the open transparency of our government agencies and their activities. (RN)

Comment: There is no way that people will know when to check a website. This is not a solution. I do check the local paper online which is how I found out about the lead permit and then spoke to the Hammond Environment office. (JH)

Comment: As an Indiana tax-payer, I oppose IDEM's proposed elimination of printing public ads. It's too vital a public service to discontinue. Many Hoosiers don't even have internet, so how would these folks learn about these notices. (SCL)

Comment: I suffer from lung problems and appreciate that agencies care enough to notify me about dangers to my health via printed notices. As you probably know, the public has various levels of electronic expertise, and those who don't have the skills to avail themselves of electronic notifications are at a real loss. Even

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for those who do have the ability to tune in, who wants to visit numerous agency websites to find the latest warnings? I know I don't have the time for that. With work, family responsibilities, and other daily distractions, the public must be advised of health dangers in the most accessible way possible, and that would be through print media, possibly supplemented by radio and TV. (KR)

Comment: It seems shortsighted to expect anyone to check obscure websites for information. The government is to be transparent. Only when public records can be retrieved for reference and verification is it transparent. Information can be changed if not in print. Trying to save $17,000 is laughable. Raise taxes to provide necessary services government should provide all of us. I am opposed to your proposed 'savings'. (RM)

Comment: Air pollution permits need to be kept in the public eye. Newspaper notices are by far the most effective means of getting the information out. Not everyone has access to reliable internet service and some of the elderly have problems navigating it. The idea of posting it on the web where info can be changed without any recourse sounds too 1984ish for my taste. (A3)

Comment: Please continue to publish the notices in the local newspapers, as they are the central source of legal notices for residents of the area. If every agency took the approach you are advocating, it would become virtually impossible to follow all the pending actions, meetings, etc., that are conducted by public agencies. You must also consider the burden put on the public to constantly check your website, along with any other agency website that would post notices as you are considering doing. The local newspaper is one I read daily and each day, I do read the legal notices for information about what my government bodies are doing or have done. (ERF)

Comment: We do not want, and many are not able to access, governmental websites to comb through for announcements that may be important. (A4)

Comment: Many of the polluted areas are located where there is government subsidized housing. How many disadvantaged Hoosiers have computers or would use their computer to check multiple government websites on a weekly basis to see whether anything has been posted that will directly affect or interest them? Speaking for myself, I rely on newspapers for this information and would consider it an unacceptable inconvenience to get the information as IDEM is proposing. IDEM would be imposing an unnecessary burden upon Hoosiers by eliminating the air pollution public notice ads. The inconvenience is not worth the estimated $17,000 per year savings in advertising costs. (DS)

Comment: 1.) Indiana does not provide affordable internet service to all of its citizens. 2.) Indiana lacks the capability to provide an easily navigable way of announcing and accessing this type of information. I say this because I am an income tax preparer who must deal with the DOR's ineptitude every tax season in regard to electronic filing of individual tax returns. Indiana seems to be way behind the times in regard to technology advancements and availability to its citizens. (JDM)

Comment: I am web literate but I do not relish the thought of having to go to each of the Indiana government's webpages to see if there are any proposed changes to policy. When published in the newspaper, it gives me a better "feel" for the direction that my government is heading, where if I am reading about each individual department or agency, the overall "direction" is lost. (JWM)

Comment: Keep public notices in newspapers. Who would ever check government websites every day for these notices? (A5)

Comment: Keep using newspaper notices and use the electronic strategy, more notice is better than less. I'm a new Hoosier, and I'm underwhelmed by IDEM's vigor in keeping me safe. (PL)

Comment: I subscribe to two newspapers in order to be more informed. Yes, I do have a computer, but many do not, and even though I have a computer, I only use it for the 'social aspect' of life. A savings of $17,000.00 seems paltry considering your total budget. I am sure that amount of money could be saved by eliminating waste(s) in the department and therefore, not deprive the public of being informed. It would be so easy to use both methods of publishing, therefore, those who read the notices would have full opportunity to the advertising program and if there are some who do not read the postings, but would see the electronic version, the public would then be kept 'in the know.' It is no wonder that we, the public, feel we are becoming more and more left out of decisions we should and need to know. (MP)

Comment: Curtailing the way government informs people about environmental permit applications is not a good idea and not in the public interest. I believe people will fail to be informed if it is presented online only and not printed in newspaper. (A6)

Comment: The citizens' right to know in an easily accessible newspaper ad far exceeds in value the estimated cost of saving $17,000. The advertising of public notices, I believe, is important for an informed citizenry. It is unrealistic that we would need to check multiple websites to look for such notices and evaluate them. It is my understanding that the proposed change includes electronic notice for air pollution permits. Such notices are important, too, for the health and well-being of all of us in Indiana. (MJE)

Comment: This is a clear attempt to avoid transparency since the public would have to access your web site every day, and some people cannot do so, to try and keep up with any notices on anything your department is involved with. A public notice is to be public and is to be available to the public, whether they have internet access or not. Therefore I totally object to publishing "public" notices on the department's own web site and not in newspapers and other media. (KDK)

Comment: Publication to a website that the department maintains is inadequate notice. As the Hoosier Press Association has shown, the number of Hoosiers who visit the department's website where notices are placed is but a few hundred per week whereas the readership of Indiana's newspapers is nearly four million per week. The public has a right to know about the work of its government and the state's newspapers are the proper and reliable location for such mandated notices. (JK)

Comment: Indiana should continue to advertise increases in pollution. If you want to add information to your websites and increase access to information that is great, however decreasing access to this important information is wrong. (A7)

Comment: We should not have to hunt for such information. It should be sent to us. (A8)

Comment: We are inundated with electronic news, so to think that the general public will seek out notices on a web site is totally unreasonable. The cost of publishing notices in print is a small price to pay for our health. I would encourage you to do both: post on your web site and continue to publish in local papers. (DSt)

Comment: Presumably, the purpose of a "Public" Notice is to make its contents public. Newspaper subscribers read their newspapers. This is especially true in smaller communities. Few Hoosiers waste time browsing through countless government websites looking for things they know nothing about, and in which they have no prior interest. This is the first time I have had occasion to interface electronically with

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"Environmental Management" and, hopefully, the last. Posting "Public" Notices only online would be the equivalent of burying them in an abandoned graveyard. Don't do it. (RLK)

Comment: I always believed that the role of IDEM is to help protect residents of Indiana from pollution and to ensure companies, businesses and individuals comply with the laws that protect our environment. One of the best ways to ensure compliance, is to bring compliance into the light; that is, make the public aware of any type of action by your agency. This has been achieved in large part through the reporting of your actions via Indiana newspapers, which includes placing your "public notices" in Indiana newspapers. Oftentimes, the "public notice" itself prompts a news story which further brings environmental news/actions into the public arena in an informative, explanatory manner. Placing any type of IDEM action, such as "air permit notices" on your website would, in my view, diminish the public's knowledge and concern about their particular local issue. The vast majority of people are not going to check your web site on a weekly basis to see if there is any "news" about their locality. However, people will read an article and/or notice in their local newspaper pertaining to the environment. For these reasons, I hope your agency reconsiders the decision to put notices on your website. (BK)

Comment: It would be difficult for people to find information unless they are proficient with computers, most are not. With corporations now self-monitoring, I wonder who we will turn to when problems arise in the future. (KC)

Comment: If you want to keep providing information to many Indiana residents, continue your public notices in local newspapers. If you want to limit the information to fewer people, only place it on the IDEM website. (JCDJR)

Comment: It is important that these types of notices remain available to the public through print media. Online notification in addition to print is fine, but there are those who do not have access to electronic sources whose lives and health can be negatively impacted by the proposal. This is especially true in rural areas such as in Jefferson County where not every household has internet access. (JMS)

Comment: If you want to put the info on the website, fine. But that alone is not sufficient. The information is too critical and important for keeping the public informed. It must be made known and there are still members of the public who read newspapers. (DSp)

Comment: Moving public notices from newspapers to a state run website will greatly diminish the exposure of such notifications. This is nothing more than a blatant political move to prevent potential opposition to unpopular positions. Multiple surveys have demonstrated that the majority of Indiana residents prefer to receive public notice advertising through easily accessible newspapers. Unlike newspapers, Internet access is not universally available. IDEM's explanation of communicating "more quickly and efficiently" is nothing more than bureaucratic doubletalk. (JKu)

Comment: Do we really expect that citizens will regularly go to IDEM's website to see there are new petitions to pollute? Surveys find that 85% of Hoosier respondents prefer that notices be posted in newspapers and are likely to read these. Obviously, many fewer people will look for an electronic notice on IDEM's website. This proposal smacks of trying to hide this information from the public. It is not a reputation that our government, paid by Hoosier taxpayers, should want. The proposed change does not serve the people. It serves the wanna-be polluters. (MHir)

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Comment: Please continue to post public notice advertisements in local papers rather than make taxpayers hunt various websites to find what should be easily accessible notices. I am not in favor of the proposal to stop newspaper publications of these notices. (A10)

Comment: I much prefer if IDEM continued to publish notifications in local newspapers so that people have a real shot of seeing these notifications. (WS)

Comment: The public deserves to know what is going on in their community. It would be very wrong to further hide what industrial facilities are doing. We have enough trouble finding the tiny notices in the newspaper, and now you're considering posting them only on your website where most people would never see them. Please don't make this change. (MMa)

Comment: When an industrial facility seeks permission to emit air pollutants, with just putting that notice on IDEM's website is not a good idea. Please continue to place public notices in local newspapers when industrial facilities wish to emit air pollutants into the air. Not only is this is a very bad idea it is not transparent and certainly does not serve the best interests of the citizens most affected. It is a misguided proposal that makes it much more difficult for Hoosiers to find information they are used to getting in local newspapers and this certainly is not a move for transparency. Even in our ignorance you have a responsibility to protect us and have the citizens best interest in mind at all times. (A11)

Comment: When an industrial facility seeks permission to emit air pollutants, with just putting that notice on IDEM's website is not a good idea. Please continue to place public notices in local newspapers when industrial facilities wish to emit air pollutants into the air. Not only is this is a very bad idea it is not transparent and certainly does not serve the best interests of the citizens most affected. Your website is not considered a public access for information, although the public may have access to it not all of the public has access to the internet therefore making it inaccessible to all of the public, whereas the newspaper is available to all venues. (A12)

Comment: Relegating industrial pollution notices to an agency website is offensive to the public on so many levels! People cannot act on what they do not know. (A14)

Comment: Currently, IDEM has to notify residents via an ad in local newspapers. I think this is a good rule, and should be kept. It means people have a real chance at seeing that advertisement. I have read that IDEM wants to change this rule so that IDEM only has to post these types of notices on its website. I believe this will make people less informed about and thus less able to resist polluters in our neighborhoods and communities. Please do not authorize this rule change. (VSt)

Comment: It's too hard for people to find this information on your website. I had to call your office and talk to you to get directions on where to find the public comment period for this proposed rule change. Doing this will be very difficult and therefore largely inaccessible for the average Indiana citizen! If it is this difficult to submit comments on the proposed rule change, how can we trust the IDEM website will be transparent and accountable on other public comments? IDEM owes it to Indiana citizens to do their job in a transparent and accountable manner that is easily accessible to the public. I have yet to find the public comment section on the IDEM website. If we can't find it on the website, does it really exist? At least when you publish it in the newspaper there is a public record of the public notice. I urge you to not approve the proposed elimination of newspaper publication for air permitting notices. (LWe)

Comment: This could be info that may be of interest to me, but I more than likely will never see it as I don't use this way of checking out things on a computer. I would be more likely to see it in the newspaper. (DBi)

Comment: The intent of the current rules is to allow those potentially affected an opportunity to comment prior to approval of a permit or permit revision. To comment, you have to be aware of the permit proposal. Notices published on a website will be less likely seen (and therefore commented on) by those not specifically looking for them because this form of notification is very passive. Only those already aware and actively looking for such notices will find them. Newspaper ads represent a more active form of notification, especially for those that are not internet savvy. Paper copy newspaper circulations are declining, but electronic versions of the same newspapers are commonplace and efficient at reaching the internet savvy public. Thus, newspaper ads provide better visibility to those affected but not aware. Therefore, to meet the dual objective of reducing costs without reducing the opportunity to comment by those affected, I recommend that the internet address of the website containing the legal notices be published in the newspaper (paper and electronic versions) instead of the actual notices. One newspaper ad could be used for several individual notices. Just put the titles of the notices and the single website address in the ad. This won't eliminate all newspaper ad costs, but it would reduce the costs and still provide visibility to those affected but not aware and allow them an opportunity to comment. (JGr)

Comment: The proposal by IDEM to save $17,000 by eliminating notice by publication in newspapers of air permit applications is one of the silliest proposals - among many silly anti-citizen/anti-environment proposals - that IDEM has ever made. The amount to be saved is trivial. The result is the denigration of every citizen's right to clean air. It is completely understandable that businesses do not want pesky citizens interfering with business's efforts to minimize regulation and maximize profits at the expense of breathable air. Too bad that the "cost conscious" businesses and their lackeys in the legislature and administration simply ignore the proven fact that bad air increases the incidence of respiratory disease which, in turn, increases the public expenditure on health costs and the loss of productivity due to illness. You also overlook that bad air severely diminishes the attractiveness of neighborhoods for those who might think about investing in residences for their families. $17,000? Pretty much a rounding error, is it not? Operating government to serve exclusively the interests of business is a betrayal of the public trust. In spite of the many tax breaks business has received, and in spite of the many loopholes that favor the truly wealthy, there is no evidence at all to support the assertion that such toadying ever has resulted in the creation of a single job - despite the many false claims to the contrary. I read newspapers every day. I do not care to visit a government website every day. Your proposal would make it significantly more cumbersome for me to find out about projects that would directly affect the quality of my life. Your party claims to represent "the people". That is nonsense, as demonstrated by this silly proposal. (MG)

Comment: I urge the Indiana Department of Environmental Management to continue its current practice of publishing public notices for air permits in local newspapers, while also continuing to provide electronic notice. IDEM's proposed rule change would greatly reduce the availability and ease of access for Hoosiers to IDEM's air permitting decisions that impact our communities. Please do not approve the proposed elimination of newspaper publication for air permitting notices (LSA Document #17-395, Electronic Notice for Air Permits).

IDEM's rationale for the proposed rule is flawed. Many Hoosiers lack access to the Internet or experience using the web. While it's true that access to the Internet has increased in the United States, widespread adoption has not occurred uniformly in Indiana, due to demographic, economic, and geographic factors.

A Broadband Now study shows that there are about 286,000 Hoosiers without any wired Internet providers available where they live. In addition, older Hoosiers may not have experience with using the web to locate information. Given these and other limitations of IDEM's website, eliminating newspaper publication of

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notices would make it less likely that Hoosiers are informed about air pollution issues in their communities, and in a state that had made national headlines for its poor air quality, we need more, not less information.

IDEM says it will save $17,000 per year by eliminating newspaper publication of air permitting notices. This money benefits small town newspapers and the communities that depend on them and is a small price to pay to ensure that all residents of Indiana have good access to information about air permitting decisions that impact our health.

While I support IDEM providing electronic notice of all air permitting actions, the agency must provide another means to give notice of these actions to people who do not have access to the web, especially for Hoosiers who live relatively near to a particular pollution-emitting facility. Accountability and transparency are critical values that underlie our system of state government. I urge you to reject this proposal that would decrease citizen access to government decisions about these important public-health matters. (SG, DP, MPi, RD, KRe, SS, DE, RW, JM, CLMD, JLT, BBa, MMu, SSt, MC, WE, NF, AB, DH, BC, ET, JKi, JKl, NW, JC, PRH, SO, JMa, SP, BG, KL, LH, DEl, NB, RWi, SHo, LN, LR, SRC, DL, LNi, JD, MS, DG, JB, NA, NM, SSi, JCo, ML, HS, JG, SB, PS, RWo, PT, MK, PHA, DC, JGa, HSc, TK, JMe, PW, DSl, LF, MW, DLa, JS, AA, MB, AJ, BCo, MCT, NAd, PF, DW, JW, AR, WR, CB, JBl, JKir, LL, LBB, RJG, MO, JZ, SSc, MGr, DK, RWe, WJ, GF, RS, BH, NP, PD, MCa, AS, JR, VG, EK, JCri, MTh, SK, ES, CBa, DGa, AG, PG, CG, LE, TLo, LGZ, JWe, MCal, JRo, RBy, DHe, RAF, LS, DB, DT, DLL, KT, EW, CW, MR, KA, EJ, MSe, MSt, HSch, JF, JBo, CS, AF, JFa, PM, WK, DKe, JCe, KOC, SN, NBu, JO, NH, JBa, EKa, JP, SM, TKo, SF, VB, KWLC, RY, MJ, SW, LP, MTi, BHa, BTW, WD, AED, SKo, RNe, CF, AGC, LSz, JMar, KM, RC, EC, EG, CM, RBa, EH, RH, MPin, LFa, JI, LW, DPi, BO, SMc, MBF, DCu, DEm, RL, SSp, LG, AFr, TC, GM, MSc, RE, RMe, MZ, RCo, KK, RF, AZ, TM, KW, DN, KN, CRe, KCa, JCa, Rcom, JHa, JMel, SC, DEH, TH, LLe, MVD, JMac, MLe, JHar, KH, SPi, ESa, LEi, MCan, PR, SFr, WU, DKi, AM, GB, RBu, MWe, DNo, BR, LV, VS, WW, DHo, JMelc, AH, JDe, AMa, GC, MJo, CGa, JWa, CP, CRea, SKe, PC, GBo, SGe, PSt, TF, KKi, AHo, WC, CE, SGr, VH, DJ, JSu, JHarr, BS, RT, PRu, JBar, BBr, LHu, TW, KB, DWC, ESu, THo, PCC, NMc, BHar, AP, JT, RSk, TLa, TS, RSt, EHo, HC, CMo, KSD, PE, ESi, CH, FDT, PWo, NE, BBe, RDJ, PN, PB, Ski, OM, SR, RHa, JWas, BL, JCar, KCu, RSte, JBla, MH, RStei, Aha, KWi, JBau, KWe, JCR, MRi, JL, JSw, CC, NMo, DM, MWi, AC, PMi, MBr, MLS, JKirk, Sha, CL, NN, CLi, JLW, JHe, CCl, AW, MQ, TSw, SBa, KD, MD, LY, DR, PBa, ESm, EHe, MCha, SL, RWil, HH, MSw, SWi, MHi, KF, KFe, LDo, JKli, MJA, LEs, CGr, BSi, GBa, LAL, ED, Ash, MCl, KMa, AL, JBlo, SBar, DRM, DLR, KCh, SE, MPa, AT, SKen, BHo, JN, MDo, DPl, LDa, LNe, JHal, DJa, KTo, MKi, KAl, SSpi, LPa, TDB, Kl, DCa, HBe, JMi, SRe, DSi, RP, BHarg, JOh, CMa, PH, FH, AWi, TMo, HL, RZ, EB, APr, EU, PK, JSt, RLa, MN, HSm, JTr, DJam, ASu, BP, CT, RB, AO, TG, EO, TGr, FG, DHa, ASt, LA, KCar, AML, MStu, GG, BW, RDu, LEv, MWh, AFru, WM, SBi, LJ, DMc, RR, CJH, JY, RNef, ASm, SCa, CRK, RSi, JBr, MChi, EGr, TWa, TMe, EBe, JRoe, BPP, ASta, BM, MT, BHow, HBa, DBu, HCr, LiH, CDV, SLe, SKin, HW, MCar, JLe, DLy, DCun, RNa, CEr, LHa)

Comment: The Hoosier State Press Association urges the Indiana Department of Environmental Management to reject a proposed rule change that would eliminate the publication requirement in Indiana newspapers for notices of New Source Review and Title V permit programs.

The IDEM proposal is based on a change by the U.S. Environmental Protection Agency public notice rule provisions. Unfortunately, the EPA change is based on a flawed premise: "The EPA anticipates that e-notice...will enable permitting authorities to communicate permitting and other affected actions to the public more quickly and efficiently..."

Yes, e-mail notice is easier for the IDEM staff, but that is not the goal of public notice. The goal is to inform the public of these actions and newspapers remain the most effective means to accomplish that goal.

There are nearly 4.7 million adult Hoosiers who deserve to know what actions IDEM takes that impact air quality in their communities. It's obviously impractical to mail everyone notice, so democratic governments have been tasked with choosing the most effective means to reach a maximum number of people. Newspapers have been found for hundreds of years to be that best way to reach the public for government units.

A survey this summer conducted by American Opinion Research found that 2.9 million Hoosiers read a newspaper at least once a week and the number increases to 3.6 million when you include those who read their newspaper electronically. That doesn't mean every story, ad or notice in each issue of a newspaper is read, but it puts that information into the hands of someone who has paid to have that newspaper delivered to their doorstep or laptop computer.

Compare that reach to the number of visitors to the IDEM webpages where the notices of hearings are posted. The last time HSPA checked with IDEM, the average number of unique visitors to those pages per week was 105 individuals. It was a lower number than the number of hearings being noticed by IDEM at that time - 113. It's safe to assume many of those unique visitors are representatives of businesses seeking permit approval, which would reduce the number of members of the general public who actually see these e-notices to an even smaller average.

E-notices are effective if the goal is to hide information in plain sight. Yes, the public has the ability to regularly go to the IDEM website and look for permits that might impact their specific community, but it apparently isn't happening now and won't be happening in the future. Logic should tell you that people are too busy to spend time every week checking various government websites to see if there's something that would concern them. They are accustomed though to reading their daily or weekly newspaper to discover information that affects their lives.

IDEM argues that changes in the newspaper industry make public notice advertising less effective. It's true that print readership has declined, but that's because more individuals are reading the electronic version of the newspapers. There's a lot more zeros behind 2.9 million Hoosiers reading printed newspapers than the number of unique visitors to IDEM's pertinent webpages.

IDEM complains about a service issue provided by a newly purchased newspaper. Yes, when humans are involved, you can have a hiccup with customer service, but you don't stop buying food at grocery stores because you had a bad experience at one meat counter. If service is a problem for IDEM, HSPA stands ready to help tackle those issues as it has in the past with the state Attorney General's office and the Indiana Alcohol & Tobacco Commission.

The third argument is that IDEM will save $17,000 by eliminating the public notice advertisements. That's not even a drop in the bucket for IDEM's yearly budget for its Air Permit Program - a total of $12,852,822. The cost to effectively inform Hoosiers of program hearings is 0.13 percent of the Air Permit budget, yet IDEM doesn't even want to spend that meager amount to inform the public.

The American Opinion Survey though shows Hoosiers want public notices in newspapers and are fine with their taxpayer dollars being used to make it happen. The survey found that 63 percent of adult Hoosiers supported the publication of public notices even when told it could cost government units several thousand

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dollars. And when asked if they would read these notices more often or less often if moved to government websites, the survey showed there would be a 60% drop in the readership of public notices.

A cynic might argue that government bureaucrats would prefer Hoosiers, who aren't part of the inside game, not show up at hearings and question decisions being made. Hiding information on a website that citizens aren't going to see would surely accomplish that self-centered goal.

On the other hand, publication in affected communities' newspapers of these air quality decisions does give Hoosiers an opportunity to voice their opinion. It also increases the chances a reporter will write a story, which also increases the opportunity for the public to learn about the process and its impact on the air they breathe or the ability of businesses to continue operations and provide jobs in that community.

These decisions are too important to hide on a seldom-seen webpage. Government transparency is the bulwark of a democratic government. The public needs to know what its government officials are doing to judge whether they are being represented well by those elected and by the public employees who carry out the duties of state and local government units.

In Indiana, transparency rests on a three-legged stool with the three legs comprised of the Open Door Law (IC 5-14-1.5), Access to Public Records Act (IC 5-14-3) and Public Notice Advertising law (IC 5-3-1). Without proper notice of these hearings through public notice advertising, the Open Door Law and Access to Public Records Act become useless because the public doesn't learn about the IDEM action until it's too late to act. (HSPA)

Comment: The Public Notice Resource Center (PNRC) is certain that if the Indiana Department of Environmental Management doesn't abandon its proposal to eliminate the newspaper notice requirement for New Source Review (NSR) and Title V Permit programs, the decision will eventually come back to haunt the agency.

For that reason, we urge you to speak with Heidi Grether, director of the Michigan Department of Environmental Quality (MDEQ) and Teresa Marks, former director of the Arkansas Department of Environmental Quality (ADEQ), before finalizing your ruling. Both executives suffered through major controversies that resulted from moving notices from newspapers to their agencies' websites, so they are likely to have a valuable perspective on the subject.

In September 2016, the MDEQ posted notice on its website of its draft approval of a proposal to allow Nestle Waters North America to extract significantly more groundwater in Osceola County for its Ice Mountain bottling plant in the state. Although the notice had been posted on the MDEQ website for 42 days, citizens in Michigan were shocked to learn about the proposal when a story about it was published on Oct. 31 in a local newspaper, the Grand Rapids Press, and on its website, MLive.com. MDEQ had not received a single comment on the proposal before the newspaper story brought it to light. Within three days after the article was published the agency had received 1,100 email messages about the proposal. The flood of citizen input forced the agency to extend the comment period on three separate occasions by a total of 165 days, and to schedule a public hearing. By early December, the agency had received over 3,000 comments; by April of the following year, MDEQ Director Grether said she had personally received over 35,000 emails on the subject. Speaking to a group of environmental lawyers, Ms. Grether admitted that the notice on the MDEQ website wasn't enough. "Was (the Nestle proposal) advertised and noticed in a way it should have been? Probably not, it appears to me."

In August 2012, the ADEQ approved a permit to allow Cargill and a group of local farmers to build a Concentrated Animal Feeding Operation (CAFO) on the banks of the Buffalo National River in Arkansas. Although it had been posted for 30 days on the ADEQ website, citizens in Newton County, Arkansas, were astonished when they discovered later that year that a hog farm was being built near their homes. The state of Arkansas likely has spent, at a minimum, hundreds of thousands of dollars defending and settling lawsuits filed over the hog farm. If ADEQ had instead spent a few hundred dollars publishing notices in a local newspaper, the citizens living near the farm would have had an opportunity to weigh in on the proposal and much of the conflict may have been avoided. The irony surely wasn't lost on Ms. Marks, the former ADEQ director. "I understand the way people feel," she told a local newspaper when she was still heading the agency. "They feel like this happened and nobody knew anything about it." That's what happens when state environmental agencies decide to post notices on their websites instead of local newspapers.

We have a theory of why federal and state environmental agencies persist in moving their public notices from newspapers to government websites despite clear evidence that it reduces transparency and citizen engagement and increases the risk of public outrage over controversial decisions. Employees who work at agencies like IDEM and the Environmental Protection Agency (EPA) generally work in large metropolitan regions. Like many other urban professionals, they often spend much of their day working on the internet from their computers and smartphones. They are also aware that print circulation at most newspapers has declined, as IDEM notes in the first paragraph of its proposal. So perhaps it's understandable that they come to believe that newspaper notice is a wasted expense. But it only requires a few moments of reflection on the issue to realize that despite the decline in circulation, newspapers are still far more effective at providing official notice than government websites.

First, newspapers are intrinsically superior to the internet as a communication tool for public notice because of the difference in how humans process information. Reading a newspaper is a serendipitous process. Readers always find information in newspapers they weren't expecting to see. That guarantees that public notices in local newspapers will always be seen by many people who didn't pick up the paper intending to read them. People behave differently on the internet. They tend to be more goal-directed, seeking specific information via direct access or search tools like Google or Bing. Therefore, they are unlikely to find information that they aren't looking for. That's why public notices on websites get lost and are easily hidden. The serendipity factor is especially significant with regard to public notices because few people actively seek out public notice advertising. This helps to explain why, for over 200 years, policymakers have chosen to publish notices where people are likely to find them.

Second, when public notices are eliminated from newspapers, they are also removed from newspaper websites. That's important because the great majority of newspaper websites in the state of Indiana generate significantly more traffic than the IDEM site. So by eliminating newspaper notice, IDEM is not only jettisoning print distribution. It is also vastly reducing the digital distribution of its notices.

Third, people who read local newspapers are more likely to be civically engaged than the average citizen. Of those who always vote in local elections, 27 percent are more likely to read the daily newspaper than a typical adult. Seven in 10 of those voters read newspaper media in print, online or on mobile devices in a typical week, and nearly eight in 10 contribute money to political organizations. Comments the EPA made in connection with the rule that serves as the basis for IDEM's proposal indicate that it is an agency goal to increase civic engagement in its rulemaking process. Although IDEM's proposal never addresses the issue, we presume that it is a goal of IDEM as well.

We would ask how, in light of these facts, IDEM can seriously argue that its proposal will increase transparency for NSR and Title V permit programs? However, we note that IDEM's proposed rule never

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actually claims e-notice will reach more Indiana citizens. It focuses instead on cost, convenience and expedience. Those are all worthy goals. Unfortunately, none are the primary purpose of public notice laws. (PNRC)

Comment: On behalf of Sierra Club and its over 10,000 Indiana members, we submit these comments on Indiana Department of Environmental Management ("IDEM") proposed rule, LSA Document #17-395, concerning public notice provisions for permits issued under the Clean Air Act's New Source Review ("NSR") and Title V programs, which was noticed for public comment on September 6, 2017 ("Draft Air Permit Notice Rule"). As explained below, Sierra Club urges IDEM to continue newspaper publication as the primary means of public notices for draft air permits in order to keep all Hoosiers informed of agency decisions regarding public health, and therefore better maintain transparency and accountability in state government.

The U.S. Environmental Protection Agency ("U.S. EPA") published a final rule revising the public notice provisions for the NSR and Title V permit programs last year. 81 Fed. Reg. 71,613 (Oct. 18, 2016). The U.S. EPA rule requires electronic publication of notices intended to inform the public of draft air permits, and removes the former mandatory requirement of newspaper publication. State permitting agencies, such as IDEM, may continue to supplement e-notice with newspaper or other means of notice. IDEM must select one means of notice as the official one for giving legal notice.

IDEM currently provides notice of draft air permitting decisions both through publication in a local newspaper and its website. In the Draft Air Permit Notice Rule, IDEM is proposing to terminate newspaper publication and convert entirely to e-notice, citing reduced time to notify the public, $17,000 cost savings, and expanded public access to permit-related documents.

The Clean Air Act's NSR program requires installation of state-of-the art pollution controls for certain new and modified sources of air pollution. The Title V program imposes emission limits and other requirements on major sources of air pollution. Both programs are critical components of Congress's scheme for protecting public health from air pollution.

There is no legal obligation for IDEM to terminate newspaper publication of public notices. Rather, U.S. EPA's final rule-an example of the cooperative federalism embodied by the Clean Air Act-allows state permitting authorities to supplement e-notice with newspaper notice or additional means of notification to the public, and decide which means of notice is the official one for agency purposes. Simply put, IDEM is free to choose the appropriate means for giving Hoosiers notice of these important air permitting decisions that affect their communities, and U.S. EPA's final rule has essentially no effect on IDEM's decision regarding discontinuing newspaper publication.

IDEM is wrong that the Draft Air Permit Notice Rule will "expand" access to permitting decision-making. IDEM suggests that its proposed rule will somehow increase access to agency decision-making because more people are using the Internet. But IDEM already publishes notices of draft permits on its website. Hoosiers who have access to the Internet-and the time and inclination to search for air permit decisions-can already get access to this permitting information. Moreover, a fundamental problem with IDEM's proposal to rely on e-notice alone is that it imposes a state-created obligation on citizens to periodically check IDEM's website for public-health information. And while it is true that Internet usage has increased in the United States in the last decade, 23.1% of Hoosiers still do not use the Internet at all. This means approximately 1.5 million Hoosiers would have no access to public notices if IDEM solely relies on e-notification.

Many Hoosiers do not have the resources or time to accept the obligation to search IDEM's website. Most Hoosiers are accustomed to look to their local newspaper for information affecting their communities. Thus, IDEM's Draft Air Permit Notice Rule, if adopted, will very likely decrease public awareness of IDEM air permits. According to the IDEM website, "IDEM ensures that regulated entities comply with federal and state environmental laws and rules that help protect Hoosiers and [the] environment [and] educates the public about air quality issues and agency decisions." Without Internet access or the time to search the web, many Hoosiers would be left uninformed of air quality issues if IDEM's proposal is adopted.

With an opportunity to comment on draft air permits for facilities located in their own backyards, Hoosiers would have the ability to ensure that IDEM complies with the law and adequately protects public health. In order to maintain agency transparency, IDEM needs to ensure that all Hoosiers stay informed and can voice their opinions through the public comment process. This transparency is vital to increasing community engagement and building trust that Hoosiers' input is accounted for in agency decisions. IDEM has tremendous responsibilities to implement the Clean Air Act to protect public health-and Hoosiers deserve to have actual notice of important IDEM decisions that impact their communities.

In its Draft Air Permit Notice Rule, IDEM wrongly suggested that its proposed rule might expand access to agency decision-making. As explained above, this is incorrect because the agency already provides e-notice, and the only practical effect of the proposed rule would be to eliminate newspaper notice which many Hoosiers rely on. Accordingly, there are no actual benefits of the proposed rule other than saving IDEM some money.

In addition, IDEM appears to have failed to weigh the benefits that Indiana newspapers provide to Indiana communities. Local newspapers rely on advertisements to stay in business, and IDEM's notices are a small part of that business. The $17,000 that IDEM spends on air permit notices benefits these local newspapers, their employees, and readers. This money also benefits the local economy more broadly through economic multiplier effects. Rather than contribute to the decline of print media, IDEM should view its newspaper publications, in part, as a way to help local communities economically and sustain citizen engagement.

We believe that $17,000 a year is an appropriate amount to spend to maintain and improve public access to IDEM's decision-making. But, at a minimum, IDEM has not appropriately weighed the costs and benefits of terminating newspaper publication. Thus, IDEM has not met its obligations to make reasoned decisions. (SC)

Comment: Rather than eliminate one method of notification for air quality issues, why not improve the notification by using both? If the proposed cost savings is $17,000, I would think that 17 cases of childhood asthma at a medical cost of $1,000 per child is a small price to pay for Hoosier health. Penny wise and pound foolish. (BB)

Comment: It would be the height of foolishness to change from printed to electronic notifications concerning industrial waste etc. This is clearly a plan cooked up for the convenience of the people doing the job, and just another way to get out of some work, and certainly not for the purpose of informing the public. Look at the polls of those in favor and opposed, then do the people's wishes. And in a state budget $17,000 is peanuts. (TL)

Comment: The safety of the people of Indiana is worth more than your proposed savings. This smacks of an underhanded profit motive dealing. At some point, the health of American citizens should come before profit. If not you will see Democrats in office in both 2018 and 2020. Think about this, is a paltry $17K worth it? I vote and I have a loud mouth! (KG)

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Comment: To save 17,000? Silliness. Newspaper notices should continue. (A9)

Comment: This is what is called "business friendly". Make it easier for a greed head to forge ahead with polluting while collaterally developing support for his/her entity from the economic vibrancy that the pollutants create. Helluva deal for anyone not sickened by the toxicity. (TDS)

Comment: Those from NW Indiana suffer from poor air quality as it is. Profit before people is standard practice in this state. Your agency is well known for this. (SH)

Comment: You want transparency from your government agencies, especially when it comes to public health. (BBa)

Comment: As a taxpayer and lifelong resident of Indiana I do not want the elimination of public air pollution notices eliminated from being posted in public newspapers. It is important as most people do not go online or follow government websites routinely to be aware of such postings. Saving a few dollars does not justify this action of eliminating published public notices and it takes away from the open transparency of our government agencies and their activities. (RN)

Comment: Any move by a governing body to be less transparent in dealings that affect their voting constituency without their knowledge can only be interpreted in a limited way and in a negative light. The government exists to serve the people, not the other way around and as such, we must insist on the continued transparency from those we place in positions of authority. Ignorance should never be misconstrued as compliance. Please refrain from removing this information from local papers. (A13)

Comment: In my area of northeast Henry County, we depend on the local newspaper to find out what is transpiring in the county. At the edge of my road frontage, there are three "No Wind Farm" signs spaced approximately 1-200 feet apart. They would not have been there without the local paper and the all of their coverage. Companies like the ones trying to sneak their way into areas like ours----areas that are not right for wind farms----rely on state agencies like you to look the other way. Just remember, you are an agency of the state, and the state is the people who populate it. You should operate in the best interest of the people. We have invested a lot of money buying our acreage, building a beautiful home, and producing crops. We have been here for 33 years, and I don't want to spend the rest of my days seeing and listening to the wind turbines!!! (A15)

Comment: IDEM wants to stop putting notices in the newspaper about industrial pollution. This is not the way our country works. I disagree with their desire to hide from the public their intentions. (SHan)

Comment: What is your department trying to hide? This is a horrible idea! How long did it take to come up with this idea? Your department is supposed to work for the people, not against it. Please re-think this unthinkable action. (SSh)

Comment: I would like to encourage you to continue to put notices of new pollution in the newspapers and not just post them on your web site. The public is interested in their community and need to know about these changes. We are counting on you to keep the public informed! (A16)

Comment: The notices were small before and easy to miss but now nothing? Do you have something to hide? Even if it is on your web site it could still be missed. I feel this is wrong and should be reconsidered. (A17)

Response: IDEM received a total of 546 comments during the comment period for this rulemaking. IDEM appreciates the time and effort of the members of the public who submitted comments for this rulemaking, and each comment has been considered in IDEM's response.

IDEM recognizes that some Indiana residents still prefer to read newspapers as the main source of information for permit actions. However, multiple studies over the years have shown that the global newspaper industry is shifting steadily towards digital platforms. Two-thirds of all adults now use some form of social media as the primary source of their news, and 55 percent of Americans 50 years old or older are now using social media for news updates. [**3] According to the same Broadband Now study mentioned in the comments received from Sierra Club, 86 percent of Hoosiers have internet access and one hundred percent have access to mobile broadband services. [**4] IDEM has a responsibility to keep pace with these trends in order to continue providing the best service to the public, and electronic publication of notices is at least as effective, and in many cases, more effective, in providing notice to the public about draft air permits.

As a result of the decline experienced by the newspaper industry over the years, printed newspaper advertisements have become less effective in providing widespread public notice of permit actions. As more newspapers are going out of business or being bought by out-of-state companies, publication delays are occurring more frequently, which negatively affects the timely issuance of agency permits. Consequently, this negatively impacts businesses seeking permits. Additional delays are caused by newspapers that have reduced print circulation to just once or twice per week, or newspapers that shut down for periods of time over holiday breaks. Given the fact that information on the internet today is plentiful and largely free, people are more likely than ever before to forego paying for newspaper service and opt for internet service instead.

It is important to distinguish between a notice published under a public notice section in the back of a newspaper, versus an article about a permit action on the front page or featured within the newspaper. The public notice only provides a brief description of the permit action, and provides information on how to locate copies of the documents. A newspaper article, however, contains significantly more information for the reader and is far more likely to be seen and read by newspaper subscribers. Nothing in this proposed rulemaking action limits the ability of journalists to cover permitting actions relevant to their readers. IDEM encourages newspaper staff to visit IDEM's public notice webpage or request to receive mailed copies of notices related to actions that may be of interest to their subscribers, and provide information to their readers through an article about the permit action.

Several of IDEM's program areas already publish public notices on the department webpage. These notices can be found at http://www.in.gov/idem/5474.htm. Additionally, IDEM's air permitting program has a searchable online database for the public to use that links directly to the public notices and is found at http://www.in.gov/ai/appfiles/idem-caats/. Public notices posted on IDEM's webpage can be accessed for the duration of the public comment period, as opposed to only one day in a newspaper ad. The longer availability of public notices online increases the likelihood that interested parties will be able to read pertinent draft permits, and reaches additional audiences who may not subscribe to a local newspaper but are able to access the notice and associated documents online.

IDEM understands that a major public concern of switching from newspaper notices to electronic notices is that many people do not have regular access to a computer, or enough knowledge or familiarity with using computers, to find the information they are seeking on IDEM's website. However, even in the currently published newspaper notices, the information IDEM provides in the ad is limited. In order to read the full details about the permit action contained in the notice, readers must access an online link that is provided in the body of the notice or visit a local library in order to review the documents.

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Citizens also commented that searching IDEM's webpage for pertinent notices would take too much time and effort. IDEM has already addressed this concern by providing the direct link to the public notices on our website. Additionally, members of the public who are interested in knowing about permit actions that affect the area where they live can have their name added to IDEM's Office of Air Quality Permits Interested Parties list. Individuals on this list receive a paper copy of the permit action through the regular postal service any time a permit action in their area goes to public notice, and again once the permit is issued. People can choose to have their names added to the list for permit actions in a specific county or multiple counties, or for permit actions pertaining to just one source or multiple sources. This allows interested parties to receive the information directly at their home or business so that they do not have to navigate an online webpage. Anyone who would like their name added to the Office of Air Quality Permits Interested Parties list may contact Patty Pear at (317) 233-6875. Additionally, individuals may subscribe to the agency email notification system to receive email notifications for public notices based on geographic region, by visiting http://www.in.gov/idem/5474.htm.

One commenter suggested that permit notices will be difficult to access on the website due to difficulty accessing rulemaking documents. Nothing in this rule affects how rulemaking documents are published for public notice. Publication of rulemaking notices and documents is a separate and distinct process from publication of permit notices. Not only are rulemaking documents published on a different webpage from permit notices, they are also not published in any newspapers.

Several comments focused on concerns related to those citizens who may not have easy access to a computer due to being elderly, living in a rural location, or having low education or socio-economic status. IDEM understands these concerns but does not believe that these groups would be significantly adversely affected by this rule. Internet access is widely available, even for those who do not own a computer. Public libraries are a great resource for free computer use and internet access, and a 2010 study conducted by the University of Washington found that those living below the poverty line took the greatest advantage of library computer use, with 44 percent reporting use of public library computers to access the internet within the previous year. [**5] Additionally, this rule does not prevent IDEM from using newspaper notices as a supplement to the electronic notice. This rule simply allows IDEM to use electronic notices as the primary and consistent method of notice for permit actions.

Some commenters were concerned with the issue of transparency, and stated that IDEM would not be fully transparent to the public if it only publishes notices on the department website, as opposed to in a newspaper. However, there is nothing inherently beneficial or neutral in an agency publishing notices through a newspaper instead of its website, as newspapers simply act as a vehicle for publishing notices prepared and provided by the permitting authority. Historically, newspapers were used to provide public notice because there was no comparable alternative method to disburse widespread notices to the public until internet usage became more common.

In regard to the $17,000 savings IDEM will achieve from eliminating newspaper notices, IDEM disagrees that this amount is insignificant. There are costs associated with maintaining and posting information on the agency website as well; therefore, replicating these notices in a newspaper at an additional cost is unnecessary. Eliminating the amount the agency spends on newspaper notices will allow IDEM to streamline its funding and resources.

U.S. EPA's final rule gives permitting authorities the option to use either electronic or newspaper notice as the primary means of public notice. As previously stated, the federal rule does not preclude IDEM from also publishing permitting notices in newspapers. However, in the interest of providing access to important information to as many members of the public as can reasonably be expected to be interested, IDEM believes

that electronic notice is the best method of primary communication for public notice of permit actions going forward.

**1 Pew Research Center, State of the News Media 2016 (Jun. 16, 2016).

**2 U.S. Department of Commerce, National Telecommunications & Information Administration, Digital National Data Explorer, available at *https:// www.ntia.doc.gov/other-publication/2016/digitalnation-data-explorer*.

**3 Pew Research Center, News Use Across Social Media Platforms 2017.

**4 Broadband Now, Internet Service in Indiana.

**5 Samantha Becker, et al., Opportunity for All: How the American Public Benefits from Internet Access at U.S. Libraries, 2010.

REQUEST FOR PUBLIC COMMENTS

This notice requests the submission of comments on the draft rule language, including suggestions for specific revisions to language to be contained in the draft rule. Comments may be submitted in one of the following ways:

(1) By mail or common carrier to the following address:

LSA Document #17-395 Electronic Notice for Air Permits

Keelyn Walsh

Rules Development Branch

Office of Legal Counsel

Indiana Department of Environmental Management

Indiana Government Center North

100 North Senate Avenue

Indianapolis, IN 46204-2251

(2) By facsimile to (317) 233-5970. Please confirm the timely receipt of faxed comments by calling the Rules Development Branch at (317) 232-8922.

(3) By electronic mail to kwalsh@idem.in.gov. To confirm timely delivery of submitted comments, please request a document receipt when sending the electronic mail. **PLEASE NOTE: Electronic mail comments**

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will NOT be considered part of the official written comment period unless they are sent to the address indicated in this notice.

(4) Hand delivered to the receptionist on duty at the thirteenth floor reception desk, Office of Legal Counsel, Indiana Government Center North, 100 North Senate Avenue, Indianapolis, Indiana.

Regardless of the delivery method used, to properly identify each comment with the rulemaking action it is intended to address, each comment document must clearly specify the LSA document number of the rulemaking.

COMMENT PERIOD DEADLINE

All comments must be postmarked, faxed, or time stamped not later than May 18, 2018. Hand-delivered comments must be delivered to the appropriate office by 4:45 p.m. on the above-listed deadline date.

Additional information regarding this action may be obtained from Keelyn Walsh, Rules Development Branch, Office of Legal Counsel, (317) 232-8229 or (800) 451-6027 (in Indiana).

DRAFT RULE

Notice of Public Hearing

Posted: 04/18/2018 by Legislative Services Agency

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