911 A.2d 362
Supreme Court of Delaware.

William **STONE** and Sandra **Stone**, derivatively on Behalf of Nominal Defendant AmSOUTH BANCORPORATION, Plaintiffs Below, Appellants,
v.
C. Dowd **RITTER**, Ronald L. Kuehn, Jr., Claude B. Nielsen, James R. Malone, Earnest W. Davenport, Jr., Martha R. Ingram, Charles D. McCrary, Cleophus Thomas, Jr., Rodney C. Gilbert, Victoria B. Jackson, J. Harold Chandler, James E. Dalton, Elmer B. Harris, Benjamin F. Payton, and John N. Palmer, Defendants Below, Appellees,
and
AmSouth Bancorporation, Nominal Defendant Below, Appellee.

No. 93, 2006.
|
Submitted: Oct. 5, 2006.
|
Decided: Nov. 6, 2006.

Synopsis

Background: Shareholders brought derivative action on behalf of corporation against 15 present and former directors, alleging that they had failed to ensure that a reasonable federal Bank Secrecy Act compliance and reporting system existed. The Court of Chancery, New Castle County, 2006 WL 302558,dismissed the complaint for failure to satisfy pre-suit demand requirements. Shareholders appealed.

Holdings: The Supreme Court, Holland, J., held that:

[1] a failure to act in good faith is not conduct that results, ipso facto, in the direct imposition of corporate fiduciary liability;

[2] necessary conditions predicate for director oversight liability are utterly failing to implement any reporting or information system or controls, or consciously failing to monitor or oversee operations of such a system; and

[3] report issued by independent consultant refuted shareholders' allegations, and thus there was no basis for oversight claim.

Affirmed.

West Headnotes (17)

[1] **Corporations and Business Organizations**
Demanding Action and Refusal of Corporation, Directors or Officers to Act

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
101k2036 In general
(Formerly 101k206(1))

By its very nature a derivative action impinges on the managerial freedom of directors.

3 Cases that cite this headnote

[2] **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))

Right of a stockholder to prosecute a derivative suit is limited to situations where either the stockholder has demanded the directors pursue a corporate claim and the directors have wrongfully refused to do so, or where demand is excused because the directors are incapable of making an impartial decision regarding whether to institute such litigation.

24 Cases that cite this headnote

[3] **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
(Formerly 101k211(5))

Allegations in a shareholder derivative action of demand futility must comply with stringent requirements of factual particularity that differ substantially from the permissive notice pleadings governed solely by general rules of pleading. Chancery Court Rules 8(a), 23.1.

10 Cases that cite this headnote

[4] **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))

To excuse demand in the absence of a business decision, a court must determine whether or not 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.

21 Cases that cite this headnote

[5] **Corporations and Business Organizations**
Fiduciary duty in general

Corporations and Business Organizations
Good faith

101 Corporations and Business Organizations
101VI Shareholders and Members

101VI(B) Rights and Liabilities as to Corporation and Other Shareholders or Members
101k1522 Nature of Relation
101k1524 Fiduciary duty in general
(Formerly 101k174)
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
101k1844 Good faith
(Formerly 101k310(1))

A failure to act in good faith is not conduct that results, ipso facto, in the direct imposition of corporate fiduciary liability.

11 Cases that cite this headnote

[6] **Corporations and Business Organizations**
Fiduciary duty in general

Corporations and Business Organizations
Good faith

Corporations and Business Organizations
Loyalty

101 Corporations and Business Organizations
101VI Shareholders and Members
101VI(B) Rights and Liabilities as to Corporation and Other Shareholders or Members
101k1522 Nature of Relation
101k1524 Fiduciary duty in general
(Formerly 101k174)
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
101k1844 Good faith
(Formerly 101k310(1))
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
101k1845 Loyalty
(Formerly 101k310(1))

Failure to act in good faith may result in corporate fiduciary liability because the requirement to act in good faith is a subsidiary element, i.e., a condition, of the fundamental duty of loyalty.

78 Cases that cite this headnote

[7] **Corporations and Business Organizations**
Loyalty

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
101k1845 Loyalty
(Formerly 101k314(.5))
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
(Formerly 101k314(.5))

Because a showing of bad faith conduct is essential to establish director

oversight liability, the fiduciary duty violated by that conduct is the duty of loyalty.

63 Cases that cite this headnote

[8] **Corporations and Business Organizations**
Fiduciary duty in general

Corporations and Business Organizations
Duty of care in general

Corporations and Business Organizations
Good faith

Corporations and Business Organizations
Loyalty

101 Corporations and Business Organizations
101VI Shareholders and Members
101VI(B) Rights and Liabilities as to Corporation and Other Shareholders or Members
101k1522 Nature of Relation
101k1524 Fiduciary duty in general
(Formerly 101k174)
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
101k1843 Duty of care in general
(Formerly 101k314(.5), 101k310(1))
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
101k1844 Good faith
(Formerly 101k314(.5), 101k310(1))
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
101k1845 Loyalty
(Formerly 101k314(.5), 101k310(1))

Although good faith may be described colloquially as part of a "triad" of corporate fiduciary duties that includes the duties of care and loyalty, the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty.

58 Cases that cite this headnote

[9] **Corporations and Business Organizations**
Fiduciary duty in general

Corporations and Business Organizations
Duty of care in general

Corporations and Business Organizations
Good faith

Corporations and Business Organizations
Loyalty

101 Corporations and Business Organizations
101VI Shareholders and Members
101VI(B) Rights and Liabilities as to Corporation and Other Shareholders or Members
101k1522 Nature of Relation
101k1524 Fiduciary duty in general
(Formerly 101k174)
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

101k1843 Duty of care in general
(Formerly 101k314(.5), 101k310(1))
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
101k1844 Good faith
(Formerly 101k314(.5), 101k310(1))
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
101k1845 Loyalty
(Formerly 101k314(.5), 101k310(1))

Only the duties of care and loyalty, where violated, may directly result in corporate fiduciary liability, whereas a failure to act in good faith may do so, but indirectly.

28 Cases that cite this headnote

[10] **Corporations and Business Organizations**
Fiduciary duty in general

Corporations and Business Organizations
Good faith

Corporations and Business Organizations
Loyalty

Corporations and Business Organizations
Individual Profits or Benefits from Corporate Business

101 Corporations and Business Organizations
101VI Shareholders and Members
101VI(B) Rights and Liabilities as to Corporation and Other Shareholders or Members
101k1522 Nature of Relation
101k1524 Fiduciary duty in general
(Formerly 101k174)
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
101k1844 Good faith
(Formerly 101k314(.5), 101k310(1))
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
101k1845 Loyalty
(Formerly 101k314(.5), 101k310(1))
101 Corporations and Business Organizations
101VII Directors, Officers, and Agents
101VII(D) Rights, Duties, and Liabilities as to Corporation and Its Shareholders or Members
101k1873 Individual Profits or Benefits from Corporate Business
101k1874 In general
(Formerly 101k314(.5))

Corporate fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest; it also encompasses cases where the fiduciary fails to act in good faith.

24 Cases that cite this headnote

[11] **Corporations and Business Organizations**
Good faith

Corporations and Business Organizations

Loyalty

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
101k1844 Good faith
(Formerly 101k310(1))
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
101k1845 Loyalty
(Formerly 101k310(1), 101k314(.5))

A director can not act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation's best interest.

21 Cases that cite this headnote

[12] 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
(Formerly 101k310(1))

Necessary conditions predicate for director oversight liability are: (a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.

130 Cases that cite this headnote

[13] 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
(Formerly 101k310(1))

Imposition of oversight liability requires a showing that the directors knew that they were not discharging their fiduciary obligations.

74 Cases that cite this headnote

[14] Corporations and Business Organizations

Loyalty

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
101k1845 Loyalty
(Formerly 101k1843, 101k310(1))

Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.

116 Cases that cite this headnote

[15] Appeal and Error
Corporations and other organizations

30 Appeal and Error
30XVI Review
30XVI(D) Scope and Extent of Review
30XVI(D)22 Substantive Matters
30k3791 Corporations and other organizations
(Formerly 30k893(2))

Supreme Court reviews de novo a Court of Chancery's decision to dismiss a derivative suit for failure to satisfy pre-suit demand requirements. Chancery Court Rule 23.1.

5 Cases that cite this headnote

[16] 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
(Formerly 101k310(1))

Report issued by independent consultant refuted shareholders' assertion in derivative action that directors never took the necessary steps to ensure that a reasonable federal Bank Secrecy Act compliance and reporting system existed, and thus there was no basis for oversight claim seeking to hold directors personally liable for failures of corporation's employees to file required suspicious activity reports (SARs); report reflected that the board of directors received and approved relevant policies and procedures, delegated to certain employees and departments the responsibility for filing SARs and monitoring compliance, and exercised oversight by relying on periodic reports from them. 31 U.S.C.A. § 5318 et seq.

21 Cases that cite this headnote

[17] 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
(Formerly 101k310(1))

In the absence of red flags, good faith in the context of director oversight must be measured by the directors' actions to assure a reasonable information and reporting system exists and not by second-guessing after the occurrence of employee conduct that results in an unintended adverse outcome.

48 Cases that cite this headnote

***364** Court Below—Court of Chancery of the State of Delaware, in and for New Castle County, C.A. No. 1570–N.

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

Attorneys and Law Firms

Brian D. Long (argued) and Seth D. Rigrodsky, of Rigrodsky & Long, P.A., Wilmington, DE, for appellants.

Jesse A. Finkelstein, Raymond J. DiCamillo, and Lisa Zwally Brown, of Richards, Layton & Finger, Wilmington, DE, David B. Tulchin (argued), L. Wiesel, and Jacob F.M. Oslick, of Sullivan & Cromwell, L.L.P., New York City, for appellees.

Before STEELE, Chief Justice, HOLLAND, BERGER, JACOBS, and RIDGELY, Justices (constituting the Court en Banc).

Opinion

HOLLAND, Justice:

This is an appeal from a final judgment of the Court of Chancery dismissing a derivative complaint against fifteen present and former directors of AmSouth Bancorporation ("AmSouth"), a Delaware corporation. The plaintiffs-appellants, William and Sandra **Stone**, are AmSouth shareholders and filed their derivative complaint without making a pre-suit demand on AmSouth's board of directors (the "Board"). The Court of Chancery held that the plaintiffs had failed to adequately plead that such a demand would have been futile. The Court, therefore, dismissed the derivative complaint under Court of Chancery Rule 23.1.

The Court of Chancery characterized the allegations in the derivative complaint as a "classic *Caremark* claim," a claim that derives its name from *In re Caremark Int'l Deriv. Litig.* [1] In *Caremark,* the Court of Chancery recognized that: "[g]enerally where a 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." [2]

In this appeal, the plaintiffs acknowledge that the directors neither "knew [n]or should have known that violations of law were occurring," *i.e.,* that there were no "red flags" before the directors. Nevertheless, the plaintiffs argue that the Court of Chancery erred by dismissing the derivative complaint which alleged that "the defendants had utterly failed to implement any sort of statutorily required monitoring, reporting or information controls that would have enabled them to learn of problems requiring their attention." The defendants argue that the plaintiffs' assertions are contradicted by the derivative complaint itself and by the documents incorporated therein by reference.

***365** Consistent with our opinion in *In re Walt Disney Co. Deriv Litig,* we hold that *Caremark* articulates the necessary conditions for assessing director oversight liability. [3] We also conclude that the *Caremark* standard was properly applied to evaluate the derivative complaint in this case. Accordingly, the judgment of the Court of Chancery must be affirmed.

Facts

This derivative action is brought on AmSouth's behalf by William and Sandra **Stone**, who allege that they owned AmSouth common stock "at all relevant times." The nominal defendant, AmSouth, is a Delaware corporation with its principal executive offices in Birmingham, Alabama. During the relevant period, AmSouth's wholly-owned subsidiary, AmSouth Bank, operated about 600 commercial banking branches in six states throughout the southeastern United States and employed more than 11,600 people.

In 2004, AmSouth and AmSouth Bank paid $40 million in fines and $10 million in civil penalties to resolve government and regulatory investigations pertaining principally to the failure by bank employees to file "Suspicious Activity Reports" ("SARs"), as required by the federal Bank Secrecy Act ("BSA") [4] and various anti-money-laundering ("AML") regulations. [5] Those investigations were conducted by the United States Attorney's Office for the Southern District of Mississippi ("USAO"), the Federal Reserve, FinCEN and the Alabama Banking Department. No fines or penalties were imposed on AmSouth's directors, and no other regulatory action was taken against them.

The government investigations arose originally from an unlawful "Ponzi" scheme operated by Louis D. Hamric, II and Victor G. Nance. In

August 2000, Hamric, then a licensed attorney, and Nance, then a registered investment advisor with Mutual of New York, contacted an AmSouth branch bank in Tennessee to arrange for custodial trust accounts to be created for "investors" in a "business venture." That venture (Hamric and Nance represented) involved the construction of medical clinics overseas. In reality, Nance had convinced more than forty of his clients to invest in promissory notes bearing high rates of return, by misrepresenting the nature and the risk of that investment. Relying on similar misrepresentations by Hamric and Nance, the AmSouth branch employees in Tennessee agreed to provide custodial accounts for the investors and to distribute monthly interest payments to each account upon receipt of a check from Hamric and instructions from Nance.

The Hamric–Nance scheme was discovered in March 2002, when the investors did not receive their monthly interest payments. Thereafter, Hamric and Nance became the subject of several civil actions brought by the defrauded investors in Tennessee and Mississippi (and in which AmSouth ***366** also was named as a defendant), and also the subject of a federal grand jury investigation in the Southern District of Mississippi. Hamric and Nance were indicted on federal money-laundering charges, and both pled guilty.

The authorities examined AmSouth's compliance with its reporting and other obligations under the BSA. On November 17, 2003, the USAO advised AmSouth that it was the subject of a criminal investigation. On October 12, 2004, AmSouth and the USAO entered into a Deferred Prosecution Agreement ("DPA") in which AmSouth agreed: first, to the filing by USAO of a one-count Information in the United States District Court for the Southern District of Mississippi, charging AmSouth with failing to file SARs; and second, to pay a $40 million fine. In conjunction with the DPA, the USAO issued a "Statement of Facts," which noted that although in 2000 "at least one" AmSouth employee suspected that Hamric was involved in a possibly illegal scheme, AmSouth failed to file SARs in a timely manner. In neither the Statement of Facts nor anywhere else did the USAO ascribe any blame to the Board or to any individual director.

On October 12, 2004, the Federal Reserve and the Alabama Banking Department concurrently issued a Cease and Desist Order against AmSouth, requiring it, for the first time, to improve its BSA/AML program. That Cease and Desist Order required AmSouth to (among other things) engage an independent consultant "to conduct a comprehensive review of the Bank's AML Compliance program and make recommendations, as appropriate, for new policies and procedures to be implemented by the Bank." KPMG Forensic Services ("KPMG") performed the role of independent consultant and issued its report on December 10, 2004 (the "KPMG Report").

Also on October 12, 2004, FinCEN and the Federal Reserve jointly assessed a $10 million civil penalty against AmSouth for operating an inadequate anti-money-laundering program and for failing to file SARs. In connection with that assessment, FinCEN issued a written Assessment of Civil Money Penalty (the "Assessment"), which included detailed "determinations" regarding AmSouth's BSA compliance procedures. FinCEN found that "AmSouth violated the suspicious activity reporting requirements of the Bank Secrecy Act," and that "[s]ince April 24, 2002, AmSouth has been in violation of the anti-money-laundering program requirements of the Bank Secrecy Act." Among FinCEN's specific determinations were its conclusions that "AmSouth's [AML compliance] program lacked adequate board and management oversight," and that "reporting to management for the purposes of monitoring and oversight of compliance activities was materially deficient." AmSouth neither admitted nor denied FinCEN's determinations in this or any other forum.

Demand Futility and Director Independence

[1] **[2]** **[3]** It is a fundamental principle of the Delaware General Corporation Law that "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors...."[6] Thus,

"by its very nature [a] derivative action impinges on the managerial freedom of directors." [7] Therefore, the right of a stockholder to prosecute a derivative suit is limited to situations where either the stockholder has ***367** demanded the directors pursue a corporate claim and the directors have wrongfully refused to do so, or where demand is excused because the directors are incapable of making an impartial decision regarding whether to institute such litigation. [8] Court of Chancery Rule 23.1, accordingly, requires that the complaint in a derivative action "allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors [or] the reasons for the plaintiff's failure to obtain the action or for not making the effort." [9]

[4] In this appeal, the plaintiffs concede that "[t]he standards for determining demand futility in the absence of a business decision" are set forth in *Rales v. Blasband.* [10] To excuse demand under *Rales,* "a court must determine whether or not 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." [11] The plaintiffs attempt to satisfy the *Rales* test in this proceeding by asserting that the incumbent defendant directors "face a substantial likelihood of liability" that renders them "personally interested in the outcome of the decision on whether to pursue the claims asserted in the complaint," and are therefore not disinterested or independent. [12]

Critical to this demand excused argument is the fact that the directors' potential personal liability depends upon whether or not their conduct can be exculpated by the section 102(b)(7) provision contained in the AmSouth certificate of incorporation. [13] 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. [14] The standard for assessing a director's potential personal liability for failing to act in good faith in discharging his or her oversight responsibilities has evolved beginning with our decision in *Graham v. Allis–Chalmers Manufacturing Company,* [15] through the Court of Chancery's *Caremark* decision to our most recent decision in *Disney.* [16] A brief discussion of that evolution will help illuminate the standard that we adopt in this case.

Graham and Caremark

Graham was a derivative action brought against the directors of Allis–Chalmers for ***368** failure to prevent violations of federal anti-trust laws by Allis–Chalmers employees. There was no claim that the Allis–Chalmers directors knew of the employees' conduct that resulted in the corporation's liability. Rather, the plaintiffs claimed that the Allis–Chalmers directors *should have known* of the illegal conduct by the corporation's employees. In *Graham,* this Court held that "*absent cause for suspicion* there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists." [17]

In *Caremark,* the Court of Chancery reassessed the applicability of our holding in *Graham* when called upon to approve a settlement of a derivative lawsuit brought against the directors of Caremark International, Inc. The plaintiffs claimed that the Caremark directors should have known that certain officers and employees of Caremark were involved in violations of the federal Anti–Referral Payments Law. That law prohibits health care providers from paying any form of remuneration to induce the referral of Medicare or Medicaid patients. The plaintiffs claimed that the *Caremark* directors breached their fiduciary duty for having "allowed a situation to develop and continue which exposed the corporation to enormous legal liability and that in so doing they violated a duty to be active monitors of corporate performance." [18]

In evaluating whether to approve the proposed settlement agreement in *Caremark,* the Court of Chancery narrowly construed our holding in

Graham "as standing for the proposition that, absent grounds to suspect deception, neither corporate boards nor senior officers can be charged with wrongdoing simply for assuming the integrity of employees and the honesty of their dealings on the company's behalf." [19] The *Caremark* Court opined it would be a "mistake" to interpret this Court's decision in *Graham* to mean that:

> corporate boards may satisfy their obligation to be reasonably informed concerning the corporation, without assuring themselves that information and reporting systems exist in the organization 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. [20]

To the contrary, the *Caremark* Court stated, "it is important that the board exercise a good faith judgment that the corporation's information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations, so that it may satisfy its responsibility." [21] The *Caremark* Court recognized, however, that "the duty to act in good faith to be informed cannot be thought to require directors to possess detailed information about all aspects of the operation of the enterprise." [22] The Court of Chancery then formulated the following standard for assessing the liability of directors where the directors are unaware of employee ***369** misconduct that results in the corporation being held liable:

> Generally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation, as in *Graham* or in this case, ... 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. [23]

Caremark Standard Approved

As evidenced by the language quoted above, the *Caremark* standard for so-called "oversight" liability draws heavily upon the concept of director failure to act in good faith. That is consistent with the definition(s) of bad faith recently approved by this Court in its recent *Disney* [24] decision, where we held that a failure to act in good faith requires conduct that is qualitatively different from, and more culpable than, the conduct giving rise to a violation of the fiduciary duty of care (i.e., gross negligence). [25] In *Disney,* we identified the following examples of conduct that would establish a failure to act in good faith:

> A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or 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. [26]

The third of these 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, i.e., "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...." [27] Indeed, our opinion in *Disney* cited *Caremark* with approval for that proposition. [28] Accordingly, the Court of Chancery applied the correct standard in assessing whether demand was excused in this case where failure to exercise oversight was the basis or theory of the plaintiffs' claim for relief.

[5] **[6]** **[7]** It is important, in this context, to clarify a doctrinal issue that is critical to understanding fiduciary liability under *Caremark* as we construe that case. The phraseology used

in *Caremark* and that we employ here—describing the lack of good faith as a "necessary condition to liability"—is deliberate. The purpose of that formulation is to communicate that a failure to act in good faith is not conduct that results, *ipso facto,* in the direct imposition of fiduciary liability. [29] The failure to act in ***370** good faith may result in liability because the requirement to act in good faith "is a subsidiary element[,]" i.e., a condition, "of the fundamental duty of loyalty." [30] It follows that because a showing of bad faith conduct, in the sense described in *Disney* and *Caremark,* is essential to establish director oversight liability, the fiduciary duty violated by that conduct is the duty of loyalty.

[8] **[9]** **[10]** **[11]** This view of a failure to act in good faith results in two additional doctrinal consequences. First, although good faith may be described colloquially as part of a "triad" of fiduciary duties that includes the duties of care and loyalty, [31] the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty. Only the latter two duties, where violated, may directly result in liability, whereas a failure to act in good faith may do so, but indirectly. The second doctrinal consequence is that the fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith. As the Court of Chancery aptly put it in *Guttman,* "[a] director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation's best interest." [32]

[12] **[13]** **[14]** We hold that *Caremark* articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; *or* (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations. [33] Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, [34] they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith. [35]

Chancery Court Decision

[15] The plaintiffs contend that demand is excused under Rule 23.1 because AmSouth's directors breached their oversight duty and, as a result, face a "substantial likelihood of liability" as a result of their "utter failure" to act in good faith to put into place policies and procedures to ensure compliance with BSA and AML obligations. The Court of Chancery found that the plaintiffs did not plead the existence of "red flags"—"facts showing that the board ever was aware that AmSouth's internal controls were inadequate, that these inadequacies would result in illegal activity, and that the board chose to do nothing about problems it allegedly knew existed." In dismissing the derivative complaint in this action, the Court of Chancery concluded:

> This case is not about a board's failure to carefully consider a material corporate decision that was presented to the ***371** board. This is a case where information was not reaching the board because of ineffective internal controls.... With the benefit of hindsight, it is beyond question that AmSouth's internal controls with respect to the Bank Secrecy Act and anti-money laundering regulations compliance were inadequate. Neither party disputes that the lack of internal controls resulted in a huge fine—$50 million, alleged to be the largest ever of its kind. The fact of those losses, however, is not

> alone enough for a court to conclude that a majority of the corporation's board of directors is disqualified from considering demand that AmSouth bring suit against those responsible. [36]

This Court reviews *de novo* a Court of Chancery's decision to dismiss a derivative suit under Rule 23.1. [37]

Reasonable Reporting System Existed

The KPMG Report evaluated the various components of AmSouth's longstanding BSA/AML compliance program. The KPMG Report reflects that AmSouth's Board dedicated considerable resources to the BSA/AML compliance program and put into place numerous procedures and systems to attempt to ensure compliance. According to KPMG, the program's various components exhibited between a low and high degree of compliance with applicable laws and regulations.

The KPMG Report describes the numerous AmSouth employees, departments and committees established by the Board to oversee AmSouth's compliance with the BSA and to report violations to management and the Board:

> **BSA Officer.** Since 1998, AmSouth has had a "BSA Officer" "responsible for all BSA/AML-related matters including employee training, general communications, CTR reporting and SAR reporting," and "presenting AML policy and program changes to the Board of Directors, the managers at the various lines of business, and participants in the annual training of security and audit personnel[;]"
>
> **BSA/AML Compliance Department.** AmSouth has had for years a BSA/AML Compliance Department, headed by the BSA Officer and comprised of nineteen professionals, including a BSA/AML Compliance Manager and a Compliance Reporting Manager;
>
> **Corporate Security Department.** AmSouth's Corporate Security Department has been at all relevant times responsible for the detection and reporting of suspicious activity as it relates to fraudulent activity, and William Burch, the head of Corporate Security, has been with AmSouth since 1998 and served in the U.S. Secret Service from 1969 to 1998; and
>
> **Suspicious Activity Oversight Committee.** Since 2001, the "Suspicious Activity Oversight Committee" and its predecessor, the "AML Committee," have actively overseen AmSouth's BSA/AML compliance program. The Suspicious Activity Oversight Committee's mission has for years been to "oversee the policy, procedure, and process issues affecting the Corporate Security and BSA/AML Compliance Programs, to ensure that an effective program exists at AmSouth to deter, detect, and report money laundering, suspicious activity and other fraudulent activity."

The KPMG Report reflects that the directors not only discharged their oversight ***372** responsibility to establish an information and reporting system, but also proved that the system was designed to permit the directors to periodically monitor AmSouth's compliance with BSA and AML regulations. For example, as KPMG noted in 2004, AmSouth's designated BSA Officer "has made annual high-level presentations to the Board of Directors in each of the last five years." Further, the Board's Audit and Community Responsibility Committee (the "Audit Committee") oversaw AmSouth's BSA/AML compliance program on a quarterly basis. The KPMG Report states that "the BSA Officer presents BSA/AML training to the Board of Directors annually," and the "Corporate Security training is also presented to the Board of Directors."

The KPMG Report shows that AmSouth's Board at various times enacted written policies and procedures designed to ensure compliance with the BSA and AML regulations. For example, the Board adopted an amended bank-wide "BSA/AML Policy" on July 17, 2003—four months before

AmSouth became aware that it was the target of a government investigation. That policy was produced to plaintiffs in response to their demand to inspect AmSouth's books and records pursuant to section 220[38] and is included in plaintiffs' appendix. Among other things, the July 17, 2003, BSA/AML Policy directs all AmSouth employees to immediately report suspicious transactions or activity to the BSA/AML Compliance Department or Corporate Security.

Complaint Properly Dismissed

[16] In this case, the adequacy of the plaintiffs' assertion that demand is excused depends on whether the complaint alleges facts sufficient to show that the defendant *directors* are potentially personally liable for the failure of non-director bank *employees* to file SARs. Delaware courts have recognized that "[m]ost of the decisions that a corporation, acting through its human agents, makes are, of course, not the subject of director attention."[39] Consequently, a claim that directors are subject to personal liability for employee failures is "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[40]

For the plaintiffs' derivative complaint to withstand a motion to dismiss, "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."[41] As the *Caremark* decision noted:

> Such a test of liability—lack of good faith as evidenced by sustained or systematic failure of a director to exercise reasonable oversight—is quite high. But, a demanding test of liability in the oversight context is probably beneficial to corporate shareholders as a class, as it is in the board decision context, since it makes board service by qualified persons more likely, while continuing to act as a stimulus to *good faith performance of duty* by such directors.[42]

The KPMG Report—which the plaintiffs explicitly incorporated by reference into their derivative complaint—refutes the assertion that the directors "never took the necessary steps ... to ensure that a reasonable BSA compliance and reporting system existed." KPMG's findings reflect ***373** that the Board received and approved relevant policies and procedures, delegated to certain employees and departments the responsibility for filing SARs and monitoring compliance, and exercised oversight by relying on periodic reports from them. Although there ultimately may have been failures by employees to report deficiencies to the Board, there is no basis for an oversight claim seeking to hold the directors personally liable for such failures by the employees.

[17] With the benefit of hindsight, the plaintiffs' complaint seeks to equate a bad outcome with bad faith. The lacuna in the plaintiffs' argument is a failure to recognize that the directors' 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, as occurred in *Graham, Caremark* and this very case. In the absence of red flags, good faith in the context of oversight must be measured by the directors' actions "to assure a reasonable information and reporting system exists" and not by second-guessing after the occurrence of employee conduct that results in an unintended adverse outcome.[43] Accordingly, we hold that the Court of Chancery properly applied *Caremark* and dismissed the plaintiffs' derivative complaint for failure to excuse demand by alleging particularized facts that created reason to doubt whether the directors had acted in good faith in exercising their oversight responsibilities.

Conclusion

The judgment of the Court of Chancery is affirmed.

All Citations

911 A.2d 362

Footnotes

1 *In re Caremark Int'l Inc. Deriv. Litig.,* 698 A.2d 959 (Del.Ch.1996).

2 *In re Caremark Int'l Inc. Deriv. Litig.,* 698 A.2d at 971; *see also David B. Shaev Profit Sharing Acct. v. Armstrong,* 2006 WL 391931, at *5 (Del.Ch.); *Guttman v. Huang,* 823 A.2d 492, 506 (Del.Ch.2003).

3 *In re Walt Disney Co. Deriv. Litig.,* 906 A.2d 27 (Del.2006).

4 31 U.S.C. § 5318 (2006) *et seq.* The Bank Secrecy Act and the regulations promulgated thereunder require banks to file with the Financial Crimes Enforcement Network, a bureau of the U.S. Department of the Treasury known as "FinCEN," a written "Suspicious Activity Report" (known as a "SAR") whenever, *inter alia,* a banking transaction involves at least $5,000 "and the bank knows, suspects, or has reason to suspect" that, among other possibilities, the "transaction involves funds derived from illegal activities or is intended or conducted in order to hide or disguise funds or assets derived from illegal activities...." 31 U.S.C. § 5318(g) (2006); 31 C.F.R. § 103.18(a)(2) (2006).

5 *See, e.g.,* 31 C.F.R. § 103.18(a)(2) (2006).

6 Del.Code Ann. tit. 8, § 141(a) (2006). *See Rales v. Blasband,* 634 A.2d 927, 932 (Del.1993).

7 *Pogostin v. Rice,* 480 A.2d 619, 624 (Del.1984).

8 *Aronson v. Lewis,* 473 A.2d 805, 811 (Del.1984), *overruled on other grounds by Brehm v. Eisner,* 746 A.2d 244 (Del.2000).

9 Ch. Ct. R. 23.1. Allegations of demand futility under Rule 23.1 "must comply with stringent requirements of factual particularity that differ substantially from the permissive notice pleadings governed solely by Chancery Rule 8(a)." *Brehm v. Eisner,* 746 A.2d at 254.

10 *Rales v. Blasband,* 634 A.2d 927 (Del.1993).

11 *Id.* at 934.

12 The fifteen defendants include eight current and seven former directors. The complaint concedes that seven of the eight current directors are outside directors who have never been employed by AmSouth. One board member, C. Dowd **Ritter**, the Chairman, is an officer or employee of AmSouth.

13 Del.Code Ann. tit. 8, § 102(b)(7) (2006).

14 *Id.*; *see In re Walt Disney Co. Deriv. Litig.,* 906 A.2d 27 (Del.2006).

15 *Graham v. Allis–Chalmers Mfg. Co.,* 188 A.2d 125 (Del.1963).

16 *In re Walt Disney Co. Deriv. Litig.,* 906 A.2d 27 (Del.2006).

17 *Graham v. Allis–Chalmers Mfg. Co.,* 188 A.2d at 130 (emphasis added).

18 *In re Caremark Int'l Inc. Deriv. Litig.,* 698 A.2d 959, 967 (Del.Ch.1996).

19 *Id.* at 969.

20 *Id.* at 970.

21 *Id.*

22 *Id.* at 971.

23 *In re Caremark Int'l Inc. Deriv. Litig.,* 698 A.2d at 971.

24 *In re Walt Disney Co. Deriv. Litig.,* 906 A.2d 27 (Del.2006).

25 *Id.* at 66.

26 *Id.* at 67.

27 *In re Caremark Int'l Inc. Deriv. Litig.,* 698 A.2d 959, 971 (Del.Ch.1996).

28 *In re Walt Disney Co. Deriv. Litig.,* 906 A.2d at 67 n. 111.

29 That issue, whether a violation of the duty to act in good faith is a basis for the direct imposition of liability, was expressly left open in *Disney.* 906 A.2d at 67 n. 112. We address that issue here.

30 *Guttman v. Huang,* 823 A.2d 492, 506 n. 34 (Del.Ch.2003).

31 *See Cede & Co. v. Technicolor, Inc.,* 634 A.2d 345, 361 (Del.1993).

32 *Guttman v. Huang,* 823 A.2d 492, 506 n. 34 (Del.Ch.2003).

33 *Id.* at 506.
34 *In re Walt Disney Co. Deriv. Litig.,* 906 A.2d 27, 67 (Del.2006).
35 *See Guttman v. Huang,* 823 A.2d at 506.
36 ***Stone*** *v.* ***Ritter****,* C.A. No. 1570–N, 2006 WL 302558, at *2 (Del.Ch.2006) (Letter Opinion).
37 *Beam ex rel. Martha Stewart Living Omnimedia Inc. v. Stewart,* 845 A.2d 1040, 1048 (Del.2004).
38 Del.Code Ann. tit. 8, § 220 (2006).
39 *In re Caremark Int'l Inc. Deriv. Litig.,* 698 A.2d at 968.
40 *Id.* at 967.
41 *Id.* at 971.
42 *Id.* (emphasis in original).
43 *Id.* at 967–68, 971.

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2006 WL 302558
Only the Westlaw citation is currently available.

UNPUBLISHED OPINION. CHECK COURT RULES BEFORE CITING.

Court of Chancery of Delaware.

STONE, et al.
v.
RITTER, et al.

No. Civ.A. 1570-N.
|
Submitted Jan. 17, 2006.
|
Decided Jan. 26, 2006.

Dear Counsel:

Opinion

CHANDLER, J.

***1** Plaintiffs attempt to bring a derivative action on behalf of AmSouth Bancorporation ("AmSouth"), alleging that fifteen defendants-all current or former AmSouth directors-breached their fiduciary duties by failing to institute sufficient internal controls to guard against violations of the Bank Secrecy Act and anti-money laundering regulations. The Court heard argument on January 24, 2006, on the defendants' motion to dismiss the complaint. The defendants contend the pleading fails to satisfy the demand requirements of Court of Chancery Rule 23.1. At the conclusion of the hearing, the Court announced that the motion would be granted. This letter briefly summarizes the reasons for that decision.

On numerous previous occasions, this Court and the Delaware Supreme Court have urged would-be derivative plaintiffs to use the so-called "tools at hand" before filing complaints.[1] As Vice-Chancellor Lamb stated in *In re Citigroup,* the "purpose of such investigation is to enable [derivative plaintiffs] to draw complaints that satisfy Rule 23.1's requirement that facts be alleged 'with particularity' justifying demand excusal."[2] Plaintiffs in this case conducted a search of Amsouth's books and records, but their search failed to turn up any useful facts supporting their allegation that demand should be excused. Accordingly, the fact that plaintiffs made use of the "tools at hand" does not influence my decision.

The troubles for AmSouth began as early as August of 2000, when an AmSouth branch office agreed to perform custodial duties on accounts opened by two bank customers who were later convicted of running a "ponzi" scheme."[3] These two individuals-Louis D. Hamric and Victor G. Nance ("Hamric and Nance")-misrepresented to AmSouth that their business venture involved construction of medical clinics overseas.[4] When the ponzi scheme eventually collapsed, Hamric and Nance became the subject of investigations by state and federal authorities.[5] In addition, federal authorities began an investigation of AmSouth's compliance with the Bank Secrecy Act and other anti-money laundering regulations. Those regulations require, among other things, the filing of Suspicious Activity Reports ("SARs") when a bank employee has reason to suspect the bank's services are being used for illegal activities.[6]

Plaintiffs rely extensively on the findings contained in a government report prepared by the United States Department of Treasury, Financial Crimes Enforcement Network ("FinCEN").[7] The FinCEN report determined that AmSouth employees did not file SARs in circumstances where they should have. Additionally, the report concluded that

> AmSouth failed to develop an anti-money laundering program tailored to the risks of its business and reasonably designed, as required by law, to prevent the Bank from being used to launder money.... AmSouth's program lacked adequate board and management oversight.... The result was a fragmented program in which areas of the Bank had information on suspicious activity that was never communicated to those responsible for Bank Secrecy Act compliance."[8]

***2** Plaintiffs' complaint restates these conclusions-particularly the one with regard to a lack of oversight-but fails to plead *with particularity* the facts underlying the FinCEN report's conclusions. Without these facts, plaintiffs' statements taken from the FinCEN report are simply conclusory.

Before they may proceed with their derivative claim, under Rule 23.1 plaintiffs must plead with particularity the reasons why pre-suit demand would have been futile. The test for demand futility is a two-pronged test. Demand is excused if: (1) there is a reasonable doubt the directors were disinterested and independent, or (2) the pleading creates a reasonable doubt that the challenged transaction was "otherwise the product of a valid business judgment ." [9] Plaintiffs argue that, under both prongs, their failure to make demand should be excused.

First, plaintiffs contend that the board was not disinterested and independent because the defendants "face a substantial likelihood of liability" for their failure to implement adequate internal controls. [10] Plaintiffs' complaint is devoid of the particularized allegations of fact needed to tie the defendants to any of the alleged wrongdoing. Plaintiffs fail to point to any facts either showing how the Hamric and Nance scheme, or any other problems at AmSouth, waved a "red-flag" in the face of the board. Nor do plaintiffs point to facts suggesting a conscious decision to take no action in response to red flags. Without these well-pled allegations, there is no possibility the defendants faced a substantial likelihood of liability.

Second, plaintiffs contend that demand is excused because, under the second prong, the directors made no business judgment with regard to internal controls, but instead "consciously and intentionally disregarded their responsibilities after the Hamric-Nance scheme highlighted deficiencies with AmSouth's BSA/AML compliance program." [11] According to plaintiffs, demand is excused because the board "failed to exercise *any* business judgment and failed to make any good faith attempt to fulfill [the directors'] fiduciary duties." [12] Plaintiffs assert, citing this Court's recent *Disney* decision, [13] that the defendants adopted "in effect, a 'we don't care about the risks' attitude concerning a material corporate decision." [14] These conclusory allegations, without supporting facts, do nothing to suggest that demand should be excused. This case is not about a board's failure to carefully consider a material corporate decision that was presented to the board. This is a case where information was not reaching the board because of ineffective internal controls. Plaintiffs have not pled any facts showing that the board ever was aware that AmSouth's internal controls were inadequate, that these inadequacies would result in illegal activity, and that the board chose to do nothing about problems it allegedly knew existed.

With the benefit of hindsight, it is beyond question that Amsouth's internal controls with respect to the Bank Secrecy Act and anti-money laundering regulations compliance were inadequate. Neither party disputes that the lack of internal controls resulted in a huge fine-$50 million, alleged to be the largest ever of its kind. The fact of those losses, however, is not alone enough for a court to conclude that a majority of the corporation's board of directors is disqualified from considering demand that AmSouth bring suit against those responsible. The complaint completely fails to set forth adequate reasons why demand is excused.

***3** For the foregoing reasons, the complaint is dismissed. In accordance with Rule 15(aaa), the dismissal will be with prejudice.

All Citations

Not Reported in A.2d, 2006 WL 302558

Footnotes

1 *See, e.g., In re Citigroup S'holders Litig.,* 2003 WL 21384599 (Del. Ch. June 5, 2003); *see also Rales v. Blasband,* 634 A.2d 927, 934-35, n. 10 (Del.1993).

2 *In re Citigroup,* 2003 WL 21384599, at *1

3 Compl. ¶ 49.
4 *Id.*
5 *Id.* at ¶ 53.
6 *Id.* at ¶ 41.
7 Compl. Ex. E
8 *Id.* at 2.
9 *Brehm v. Eisner,* 746 A.2d 244, 256 (Del.2000).
10 Pls.' Answering Br. at 25. Nothing in the complaint suggests any of the defendants were self-interested in the sense of receiving a personal benefit from their alleged failure to institute adequate internal controls.
11 Pls.' Answering Br. at 23.
12 *Id.* at 24.
13 *In re Walt Disney Co. Derivative Litig.,* 2005 WL 2056651 (Del. Ch. Aug. 2005).
14 *Id.* at 25.

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2014 WL 3350235 (N.Y.Sup.), 2014 N.Y. Slip Op. 31776(U) (Trial Order)
Supreme Court, New York.
New York County

DAVID SHAEV PROFIT SHARING ACCOUNT, f/b/o David Shaev,
Derivatively on Behalf of Nominal Defendant Barnes & Noble, Inc., Plaintiff,
v.
Leonard RIGGIO, George Campbell, Jr., Mark D. Carleton, William Dillard, II, David G. Golden, Patricia L. Higgins, Gregory B. Maffei and David A. Wilson, Defendants,
and
Barnes & Noble, Inc., Nominal Defendant.

No. 654339/2013.
July 3, 2014.

Decision and Order

Motion Sequence No. 002

***1 Melvin L. Schweitzer, J.:**

David Shaev is the settlor and primary beneficiary of the David Shaev Profit Sharing Account f/b/o David Shaev (Plaintiff). Plaintiff has initiated this putative shareholder derivative suit on behalf of Barnes & Noble, Inc., alleging breach of fiduciary duties and abuse of control on the part of Nominal Defendant Barnes & Noble, Inc. (Company or Barnes & Noble) and Defendants Leonard Riggio, George Campbell, Jr., Mark D. Carleton, William Dillard, II, David G. Golden, Patricia L. Higgins, Gregory B. Maffei, and David A. Wilson (collectively, the Individual Defendants, and with Barnes & Noble, the defendants). Plaintiff claims that the Individual Defendants violated their fiduciary duties to Barnes & Noble by failing to ensure the Company operated with appropriate internal control mechanisms. Defendants seek dismissal of the derivative suit on the grounds of lack of standing pursuant to CPLR 3211 (a) (3) and Delaware Chancery Court Rule 23.1. They also contend that Plaintiff's claims should be dismissed with prejudice. In light of the state of law on shareholder derivative suits, and more specifically the conditions under which demand is properly excused, the court grants defendants' motion to dismiss Plaintiff's amended complaint with prejudice.

Background

Barnes & Noble, a Delaware corporation, is the nation's leading provider of reading material, digital media, and educational products, operating over 1,300 bookstores and employing 45,000 workers. As of June 2014, the Company's three operating segments include B&N Retail, B&N College, and NOOK. B&N Retail comprises the Company's 700 traditional bookstores, nondigitial products, and Sterling Publishing Co., Inc. B&N College consists of 600 stores targeted for college students, selling items such as textbooks and college apparel. NOOK is composed of Barnes & Noble's digital content and NOOK devices and accessories. Together, B&N College and NOOK form NOOK Media LLC.

Individual Defendants Leonard Riggio, the founder of Barnes & Noble and Chairman of the Board of Directors, George Campbell, Jr., William Dillard, II, David G. Golden, Patricia L. Higgins, Gregory B. Maffei, and David A. Wilson, as well as newly appointed Chief Executive Officer Michael Huseby, composed the Company's nine-member Board when Plaintiff filed its amended complaint on March 14, 2014. Barnes & Noble's Board has three standing committees: the Audit Committee, the Compensation Committee, and the Corporate Governance and Nominating Committee. Wilson, Golden, and Higgins are members of the Audit Committee. Campbell, Dillard, and Golden are members of the Compensation Committee. Dillard, Higgins, and Carleton are members of the Corporate Governance and Nominating Committee.

On June 25, 2013, Barnes & Noble announced it was in the process of assessing previous years reported financial results in past Securities & Exchange Commission (SEC) 10-K filings. On July 29, 2013, Barnes & Noble filed its 2013 10-K, concluding that there was a material weakness in its internal controls over the reporting and review of the reconciliation of its Distribution Center accruals. Certain accruals for the periods prior to April 27, 2013 had been overstated, resulting in misstatements in annual and quarterly financial statements. As a result, Barnes & Noble restated previously reported financial statements for the years ended April 28, 2012, and April 30, 2011. The Company formed internal teams and hired outside advisors to remedy the internal control deficiencies and began plans to rectify the situation. In the Company's 10-Q for the first fiscal quarter of fiscal year 2014 (the period ended July 27, 2013), Barnes & Noble reaffirmed its efforts to address the issues that resulted in the restatement of results and expressed its belief that the current course of action would be effective in eliminating the material weaknesses in its internal controls by the end of the 2014 fiscal year.

***2** Barnes & Noble indicated in its 10-Q for the second fiscal quarter of fiscal year 2014 (the period ended October 26, 2013) that the SEC's New York Regional Office had begun an investigation into the Company's restatement of earnings and a separate matter related to a whistleblower's allegation that the Company improperly allocated costs between NOOK and B&N Retail.

Plaintiff filed its initial complaint on December 17, 2013, asserting that the Board breached its fiduciary duties of loyalty, good faith, and candor to the Company by facilitating the continuance of inadequate internal controls and issuing allegedly misleading statements related to such controls. Following defendants' motion to dismiss the initial complaint, Plaintiff amended its complaint pursuant to CPLR 3025 (a).

Discussion

Initially, the court has determined that the claims cited in Plaintiff's amended complaint are derivative in nature. *Kramer v W. Pac. Indus., Inc.*, 546 A2d 348, 353 (Del 1988). Barnes & Noble purportedly suffered the harm alleged here and would receive the benefit of any potential recovery. *Bader v Goldman Sachs Group, Inc.*, No. 08-CV-255(SLT)(JMA), 2010 WL 3938410, at *5 (EDNY Sept. 30, 2010) (citing *Tooley v Donaldson, Lujkin & Jenrette, Inc.*, 845 A2d 1031, 1033 (Del 2004).

In order for a derivative suit to go forward, a shareholder must either make pre-suit demand on the corporation or seek to be excused from making a demand on grounds of demand futility. *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A2d 106, 120 (Del Ch 2009). Pre-suit demand on the corporation is "a basic principle of corporate governance and is a matter of substantive law." *Grimes v Donald*, 673 A2d 1027, 1216 (Del 1996), *overruled in part on other grounds by Brehm v Eisner*, 746 A2d 244, 253 (Del 2000). As Plaintiff has admittedly not made demand on the Board, the only manner in which this claim can proceed is for the court to find that a demand would be futile under the circumstances.

Next, choice of law. New York courts follow the "internalaffairs doctrine" to decide which state's substantive law governs matters of director liability. *See e.g. Zion v Kurtz*, 50 NY2d 92, 100 (1980); *see also Globalvest Mgmt. Co. L.P. v Citibank, N.A.*, No. 603386/04, 2005 WL 1148687, at *8 (Sup Ct NY Co May 12, 2005). "Under New York's choice of law rules, the substantive law of the state of incorporation governs compliance with the demand requirement." *Lerner v Prince*, 36 Misc 3d 297, 205 (Sup Ct 2012); *see also David Shaev Profit Sharing Account v Cayne*, 24 AD3d 154, 154 (1st Dept 2005). As Barnes & Noble is incorporated in Delaware, Plaintiff's claims will be analyzed under Delaware substantive law and, most importantly, Delaware Chancery Court Rule 23.1. *Potter v Arrington*, 11 Misc 3d 297, 305 (Sup Ct 2012) (applying Delaware substantive law to a Delaware corporation in a derivative suit).

***3** Delaware requires a "threshold question of standing, focused on whether the shareholder has exhausted intracorporate remedies, namely whether the shareholder has made a demand on the board of directors." *In re Morgan Stanley Derivative Litig.*, 542 F Supp 2d 317, 321 [SDNY 2008]. In the event that pre-suit demand would be futile, a plaintiff must plead with particularity why the shareholder was justified in having demand excused. *Rales v Blasband*, 634 A2d 927, 934 (Del 1993).

Demand futility is examined with respect to the membership of the Board of Directors at the time the amended complaint was filed unless the asserted claims were "validly in litigation" at the time of the original complaint. *Braddock v Zimmerman*, 906 A2d 776, 779 [Del 2006]. A complaint that did not "satisfy the legal test for demand excusal" when originally filed is not "validly in litigation." *In re Affiliated Comp. Servs., Inc. S'holder Litig.*, C.A. No. 2821-VCL, 2009 WL 296078, at *7 (Del. Ch. Feb. 6, 2009). Plaintiff's original complaint suffered from several pleading defects, prompting defendants' motion to dismiss and Plaintiff's decision to file an amended complaint. Therefore, the original complaint was not validly in litigation when it was filed. *Id*. While there were eight members on Barnes & Noble's Board at the time of the original complaint, a ninth member, Michael Huseby, was added by the time of the amended complaint. As such, Plaintiff needs to show demand is excused for five of the nine Board members in order to reach the necessary majority figure.

In pleading demand futility, Plaintiff is tasked with satisfying Delaware Chancery Court Rule 23.1 and must "comply with stringent requirements of factual particularity that differ substantially from the permissive notice pleadings governed solely by Chancery Rule 8(a)" that simply requires a "short and plain statement showing the pleader is entitled to relief." *Brehm*, 746 A2d at 254 & n21; *Sec. Police & Fire Prof'ls. of Am. Ret. Fund v Mack*, 30 Misc 3d 663, 670 (Sup Ct 2010) (applying heightened Delaware pleading standard pursuant to Rule 23.1); *see also In re Am. Int'l Group, Inc. Derivative Litig.*, 700 F Supp 2d 419, 430 (SDNY 2010) (Rule 23.1 "imposes a pleading standard higher than the normal standard applicable to the analysis of a pleading challenged under Rule 12(b)(6)"). Directors are presumed to be disinterested and independent when performing their fiduciary obligations. *Beam v Stewart*, 845 A2d 1040, 1048-49 (Del 2004). The particularized allegations must be pleaded in a "director-by-director" fashion and conclusory statements are disfavored and rejected. *Khanna v McMinn*, No. 20545-NC, 2006 WL 1388744, at * 12, 14 (Del Ch May 9, 2006); *Levine v Smith*, 591 A2d 194, 207 (Del. 1991); *see also Scattered Corp. v Chi. Stock Exch, Inc.*, 701 A2d 70, 75 (Del 1997) ("plaintiff's 'facts' creating a reasonable doubt about the disinterestedness and independence of the . . . Committee are not facts at all. Rather they are conclusory and speculative statements, suffering fatally from a paucity of particularization."). Should a plaintiff fail to meet this heavy burden, dismissal of the suit would be warranted. *Brehm*, 746 A2d at 267. The court finds that Plaintiff has not adequately pled the reasons why demand should be excused. Plaintiff's inferences and allegations are entirely conclusory in nature and lack the specificity and particularized facts demanded by Delaware law.

***4** Two Delaware tests on the sufficiency of demand futility allegations are relevant for evaluating Plaintiff's claims: the *Aronson* test and the *Rales* test. The *Aronson* test applies when a particular business

decision is called into question, and requires the Plaintiff to plead particularized facts spawning a reasonable doubt that either "(1) the directors are disinterested and independent" or "(2) the challenged transaction was otherwise the product of a valid exercise of business judgment." *Aronson v Lewis*, 473 A2d 805, 814 (Del 1984). *Aronson* is properly reserved for conscious business decisions or self-dealing situations in which one must inquire as to whether a director personally benefitted from a transaction. *E.g. Coates v Netro Corp.*, 28 Del J Corp L 241, at *6 (Del Ch 2002). The *Rales* test governs when "the subject of a derivative suit is not a business decision of the Board but rather a violation of the Board's oversight duties." *Wood v Baum*, 953 A2d 136, 140 (Del 2008); *In re Facebook, Inc. IPO Sec. & Derivative Litig.*, MDL No. 12-2389, 2013 WL 6798160, at *17 (SDNY 2013).

Under *Rales*, "a court must determine whether or not 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. If the derivative plaintiff satisfies this burden, then demand will be excused as futile." *Rales*, 634 A2d at 933-34. A plaintiff "must adequately plead that a majority of the company's board of directors were incapable of objectively responding to a demand because they either (1) 'face a sufficiently substantial threat of personal liability,' and are thus themselves interested, or (2) 'are compromised in their ability to act independently of the interested directors.' " *Facebook*, 2013 WL 6798160, at *17 (quoting *Desimone v Barrows*, 924 A2d 908, 928 (Del. Ch. 2007)). Despite Plaintiff's assertions to the contrary, interestedness under *Rales* solely focuses on whether a director confronts a substantial likelihood of liability for Plaintiff's proffered claims. *Guttman v Huang*, 823 A2d 492, 502 (Del Ch 2003].

***5** As Plaintiff's claims amount to issues of oversight, management, and the issuance of alleged misstatements, they ultimately do not challenge specific business decisions and, thus, the *Rales* test is the proper standard with which to engage in a demand futility analysis. *Spear v Conway*, No. 401919/03, 6 Misc 3d 1023, 2003 NY Slip Op 51749(U), 2003 WL 24012118, at *5 [Sup Ct NY Co Oct. 17, 2003] (applying *Rales* in a matter alleging failure to monitor); *Guttman*, 823 A2d at 499 (applying *Rales* in a case claiming improper financial control systems); *Pirelli Armstrong Tire Corp. Retiree Med. Benefits Trust v Lundgren*, 579 F Supp 2d 520, 528 (SDNY 2008) (utilizing *Rales* to analyze a case alleging misleading public statements).

A director is interested for the purposes of demand futility if he faces a substantial likelihood of liability for Plaintiff's claims. *Facebook*, 2013 WL 6798160, at *17. Under Delaware law, directors owe their corporation and shareholders a duty of care and loyalty. *Cede & Co. v Technicolor, Inc.*, 634 A2d 345, 367 (Del 1993). The duty of care necessitates that directors make a "good faith effort to be informed and exercise judgment" in the execution of their duties. *In re Caremark Int'l Inc. Derivative Litig.*, 698 A2d 959, 968 (Del Ch 1996); *see also Aronson*, 473 A2d at 812 (directors must "inform themselves, prior to making a business decision, of all material information reasonably available to them" and "act with requisite care in the discharge of their duties"). "[T]he duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally." *Cede & Co.*, 634 A2d at 361. Barnes & Noble includes an exculpatory clause in its Certificate of Incorporation, fashioned off of Delaware General Corporation Law § 102 (b) (7), that voids potential liability for duty of care claims. Thus, Plaintiff must plead a substantial likelihood of personal liability for a duty of loyalty breach or good faith violation, which is subsumed within the duty of loyalty. In order for a breach of good faith to be found, a director must have engaged in a conscious disregard for his responsibilities or displayed an intentional dereliction of his duties.

***6** Plaintiff has failed to plead facts with the specificity required by Delaware law to suggest that the directors face a substantial likelihood of liability. The oversight claims Plaintiff levies in its amended complaint are *Caremark* claims, which are recognized by Delaware courts as "possibly the most difficult

theory in corporate law upon which a plaintiff might hope to win judgment." *Caremark*, 698 A2d at 967; *see also Desimone*, 924 A2d at 940 (Delaware courts "routinely reject" lack of oversight demand futility allegations). "*Caremark* articulates the necessary conditions predicate for director oversight liability." ***Stone v Ritter***, 911 A2d 362, 365 (Del 2006). In *Guttman*, the Delaware Court of Chancery applied *Caremark* and dismissed an action that alleged director liability for an oversight failure that precipitated an SEC investigation and restatement of financial results for multiple fiscal periods. 923 A2d at 495-96, 508. Thus, Delaware law is unquestionably clear that *Caremark* is the accepted standard under which Plaintiff's monitoring claims should be assessed.

Under *Caremark*, a plaintiff must plead with particularity that "(a) the directors utterly failed to implement any reporting or information system or controls; *or* (b) having implemented such a system or controls, [they] consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention." ***Stone***, 911 A2d at 370. The following factors are exigent to a finding of *Caremark* liability: the dearth of an audit committee or the existence of an audit committee that meets only sparingly, *Guttman*, 823 A2d at 507; a knowing failure to "implement any reporting or information systems or controls," ***Stone***, 911 A2d at 370; a willful failure to monitor existing controls, *Guttman*, 823 A2d at 506; an audit committee possessing knowledge of "red flags" and deciding to ignore them or nourish their perpetuation, *id.* at 507 (no substantial risk of *Caremark* liability when plaintiffs were unable to "plead a single fact suggesting specific red - or even yellow - flags were waved at the outside directors"); *Rattner v Bidzos*, No. Civ. A. 19700, 2003 WL 22284323, at *12 [Del. Ch. Oct. 7, 2003] ("[C]laimed red flags are only useful when they are either waived [*sic*] in one's face or displayed so that they are visible to the careful observer"). The existence of a restatement or SEC investigation, a situation essentially identical to the facts underlying Plaintiff's amended complaint, does not suggest bad faith or a conscious disregard of "red flags" in satisfaction of Rule 23.1. *See In re Intel Corp. Derivative Litig.*, 621 F Supp 2d 165, 175 [Del 2009]. There is a stark difference between the occurrence of a suboptimal outcome and the creation of grossly negligent internal controls; to find *Caremark* liability, a plaintiff needs to show a director exhibited a "conscious disregard for his duties." *Guttman*, 823 A2d at 506 (*Caremark* "premises liability on a showing that the directors were conscious of the fact that they were not doing their jobs").

***7** Plaintiff has not pled any of the critical facts outlined above. Barnes & Noble convenes an Audit Committee that meets regularly and devotes sufficient time to its work. Plaintiff concedes the Committee met twenty-seven times during fiscal years 2012 and 2013, a figure contradicting any bad faith allegations. Despite Plaintiff's identification of a confidential whistleblower who potentially was aware of control issues endemic to the Company, Plaintiff is unable to allege particularized facts clearly demonstrating that any individual member of the Board actively knew of these purported deficiencies, consciously failed to put forth any control systems, or knowingly refused to monitor those systems already in existence. Likewise, Plaintiff has neglected to point to any glaring "red flags" to which the Board knowingly remained indifferent. *Caremark* liability is not found in the event that the Board is aware of the settlement of previous suits alleging internal control problems. *See Citigroup*, 946 A2d at 129 (finding no "red flag" when past involvement in Enron scandal was not linked to case at issue). Moreover, Plaintiff's only allegation of bad faith, in which Plaintiff contends defendants Wilson, Higgins, and Golden approved the Company's misleading statements, is entirely conclusory and circumstantial.

Plaintiff's allegations, in fact, speak to the presence of adequate monitoring systems and a lack of bad faith. The fact that Barnes & Noble itself identified the internal control issues is "evidence of directorial supervision, rather than evidence of failure to supervise." *See In re Sonus Networks, Inc. S'holder Derivative Litig*, 499 F3d 47, 70 (1st Cir 2007). The actual behavior of the Audit Committee reveals that it was active and responsive; Plaintiff's perfunctory claims that the Board refused to institute satisfactory internal controls do not meet the pleading standards contemplated by Delaware law.

Further, membership on the Audit and Corporate Governance and Nominating Committees does not preclude the directors from being classified as disinterested for purposes of demand excusal under *Rales*. "[C]ourts regularly reject committee membership as a basis to excuse demand, absent detailed pleading of specific knowledge by the committee members and specific failures to meet the duties imposed on committee members." *Bohigian v Pearson*, No. 650149/10, NYLJ 1202743923395, at * 16 (Sup Ct NY Co Oct. 15,2010]. Despite Plaintiff's citation to extensive public disclosures, the substance of its complaint suffers from a paucity of particularized detail. "Plaintiff's lengthy recitation of the duties and responsibilities enumerated in those committees' charters does not supply the requisite particularity." *La. Mun. Police Emps. Ret. Sys. v Pandit*, No. 08 Civ. 7389(LTS)(RLE), 2009 WL 2902587, at *10 (SDNY Sept 10, 2009]. In sum, Plaintiff is unsuccessful in alleging any facts, let alone particularized facts, sufficient to compel the court to conclude that any director, and certainly not a majority of the directors, is substantially likely to face personal liability. "As numerous Delaware decisions make clear, an allegation that the underlying cause of a corporate trauma falls within the delegated authority of a board committee does not support an inference that the directors on that committee knew of and consciously disregarded the problem for purposes of Rule 23.1." *South v Baker*, 62 A3d 1, 17 & n6 [Del Ch 2012]. Therefore, the directors are not considered interested for the purposes of considering demand for Plaintiff's *Caremark* oversight claims.

***8** Allegations that directors failed to halt the issuance of false or misleading statements have been analyzed under *Caremark* as failure of oversight cases. *See e.g. Rattner v Bidzos*, C.A No. 19700, 2003 WL 22284323, at * 12-13 (Del Ch Oct 7, 2003); *Loveman v Lauder*, 484 F Supp 2d 259, 266, 270 (SDNY 2007). To adequately plead a breach of fiduciary duty on alleged misstatements, a plaintiff must plead particularized facts demonstrating the directors "deliberately misinform[ed] shareholders." *Malone v Brincat*, 722 A2d 5, 14 (Del 1998). Falsity or knowledge of untruth cannot be "infer[red]" to meet Rule 23.1 requirements. *Id*. Directors must have made such statements "knowingly or in bad faith," which "requires allegations regarding what the directors knew and when." *Citigroup, Inc.*, 964 A2d at 134. Under Delaware General Corporation Law § 141 (e), directors may rely in good faith on a company's records and the representations of its officers and employees. "Without more, ... the signing of financial reports is insufficient to create an inference that the directors had actual or constructive notice of any illegality for purposes of the demand excused analysis." *Rahbari v Oros*, 732 F Supp 2d 367, 380 (SDNY 2010).

Plaintiff's amended complaint does not provide information on what each director definitively knew and when, thus failing to meet its designated burden. Rather, the complaint is framed on unavailing conclusory statements and imputes willful and malicious action simply on the basis of the Restatement, SEC Investigation, and similar actions taken against Barnes & Noble in the past. Plaintiff has not persuaded the court that the Individual Defendants relied on the Company's records or representations in bad faith or were aware of the inaccuracy of the alleged misstatements. Accordingly, Plaintiff has not evinced that any director confronts a substantial likelihood of liability sufficient to excuse demand. *Malone*, 722 A2d at 14; *Citigroup, Inc.*, 964 A2d at 133.

Alternative concepts of interestedness on the part of the directors are immaterial for the *Rales* test and thus do little to further Plaintiff's argument. Allegations juxtaposing Mr. Riggio's stock sale to his interest in Barnes & Noble's activity are legally insufficient to denote interestedness. *In re IAC/InterActiveCorp. Sec. Litig.*, 478 F Supp 2d 574, 603 (SDNY 2007) ("Cursory allegations that a director made sales of company stock in the market at a time when he possessed material, nonpublic information are not sufficient to find a director interested for demand-futility purposes."); *Ferre v McGrath*, No. 06 Civ. 1684 CM, 2007 WL 1180650, at *5 (SDNY Feb 16, 2007) ("[T]he mere sale of stock, accompanied by a conclusory allegation that a director 'knew or was in a position to know' inside information at the time of the sale, is insufficient to create a reasonable doubt as to the directors' lack of interest under *Rales")*. As such, Plaintiff has not

made clear how Mr. Riggio's stock sale, reputational concerns, and dealings with Barnes & Noble render him categorically unfit to consider demand in this action.

***9** Delaware case law undoubtedly holds that a demand cannot be excused solely because the Individual Directors ultimately would have to sue themselves. *Strugala v Riggio*, 817 F Supp 2d 378, 386 [SDNY 2011]; *Guttman*, 823 A2d at 500 ("If the legal rule was that demand was excused whenever, by mere notice pleading, the plaintiffs could state a breach of fiduciary duty against a majority of the board, the demand requirement of the law would be weakened and the settlement value of so-called 'strike suits' would greatly increase, to the perceived detriment of the best interests of stockholders as investors").

Directors may also lack independence if they are beholden to interested directors as per the second prong of the *Rales* test. However, given that Plaintiff is unable to convey interestedness of any individual director, it follows that it cannot substantiate a lack of independence resulting from an interested director's influence on his colleagues. Inside directors, while not viewed as independent under NYSE or SEC rules, may still be independent when conducting a demand futility assessment under *Rales*. *In re Bank of Am. Corp. Sec., Derivative & ERISA Litig.*, 757 F Supp 2d 260, 335 [SDNY 2010] (asserting that lack of independence under NYSE Rules or the respective company's standards "does not mean these directors lack independence to disable them from fairly assessing" demand); *see e.g. In re First Bancorp Derivative Litig*, 465 F Supp 2d 112, 123 (DPR 2006); *Caviness v Evans*, 229 FRD 354, 361 [D Mass 2005]; *Landyv D'Alessandro*, 316 F Supp 2d 49, 63 [D Mass 2004].

Plaintiff's claims of non-independence relating to Individual Defendants Carleton and Maffei are typified by their focus on SEC and NYSE rules, and are consequently ineffective. Plaintiff alleges Maffei and Carleton are interested because they were elected to Barnes & Noble's Board by Liberty and are conflicted between their duties to Liberty and Barnes & Noble's shareholders. These assertions are rooted in SEC/NYSE notions of independence and do not speak to whether any Individual Director faces a substantial likelihood of liability. *Rales*, 634 A2d at 934. Moreover, the amended complaint is bereft of any particularized facts and details on why Carleton and Maffei's allegiances to Liberty preclude them from acting in the best interest of Barnes & Noble as well. "Even though [p]laintiffs are entitled to all reasonable factual inferences that logically flow from the particularized facts alleged, . . . conclusory allegations are not considered as expressly pleaded facts or factual inferences." *Sec. Police*, 30 Misc 3d at 670. Plaintiff's superficial contentions are thus insufficient.

***10** Plaintiff's grievances towards Mr. Dillard hinge on the latter's longstanding social and business relationship with Mr. Riggio. The only scenario in which Mr. Dillard's ties to Mr. Riggio matter for demand futility is if Plaintiff demonstrated Mr. Riggio was too conflicted to be able to consider a demand in this case. As explained previously, Plaintiff failed to manifest Mr. Riggio's lack of independence. Moreover, contrary to Plaintiff's conclusions, the Delaware Court of Chancery did not deduce that Mr. Dillard was beholden to Mr. Riggio. Transcript of Oral Argument, *In re Barnes & Noble Stockholder Derivative Litig.*, C.A. No. 4813-VCS [Del Ch Oct 21, 2010], at 9:19-10:5, 17:13-23, 156:10-158:15 (stating that Vice Chancellor Strine "[didn't] want this cited back to me that Strine held that you're necessarily not an independent director"). "Allegations that [the defendant] and the other directors moved in the same social circles, attended the same weddings, developed business relationships before joining the board, and described each other as 'friends,' ... are insufficient, without more, to rebut the presumption of independence." *Beam*, 845 A2d at 1051. "[Plaintiff's] allegations of mere friendship and shared work experience likely fall short of what is necessary to call into question the independence of [the director defendants]." *Zimmerman v Crothall*, C.A. No. 6001-VCP, 2012 WL 707238, at *13 (Del Ch Mar 5, 2012]. Simply put, "the naked assertion of a previous business relationship is not enough to overcome the presumption of a director's independence." *Orman v Cullman*, 794 A2d 5, 27 (Del Ch 2002).

Having decided that defendants' motion to dismiss should be granted, the court must now determine whether Plaintiff's amended complaint should be dismissed with prejudice. Because the amended complaint marks Plaintiff's second futile effort at pleading demand excusal with the requisite degree of factual particularity and Plaintiff failed to take advantage of a books and records request pursuant to Delaware General Corporation Law § 220, the court finds that the amended complaint should be dismissed with prejudice.

The fact that Plaintiff has once again failed to resolve the pleading deficiencies in its complaint offers ample support for the court's decision to dismiss with prejudice. Plaintiff had access to defendants' legal arguments on demand futility and despite its inclusion of additional verbiage and material from relevant news outlets commenting on Barnes & Noble, the complaint is still severely lacking. "The plaintiffs filed an amended complaint after the first motion to dismiss was filed. Because the plaintiffs have failed to state a claim after two opportunities to do so, the Complaint is dismissed with prejudice." *Tasini v AOL, Inc.*, 851 F Supp 2d, 734, 745 n5 (SDNY 2012).

***11** Plaintiff did not request books and records to supplement its complaint and Delaware courts have "repeatedly . . . emphasized the importance of using Section 220 [books and records requests] to investigate and plead potential fiduciary duty claims." *Litterst v Zemph Sound Innovations, Inc.*, C.A. No. 7700-ML, 2013 WL 5651317, at *7 (Del Ch Oct 17, 2013). "In the event a party fails to timely file an amended complaint or motion to amend under this section (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 . . . unless the Court, for good cause shown, shall find that dismissal with prejudice would not be just under all the circumstances." Del Ch R. 15(aaa). This standard on dismissal with prejudice is particularly pertinent for *Caremark* claims such as those of the Plaintiff. *South*, 62 A3d at 6 (granting with prejudice defendants' motion to dismiss for failure to plead sufficiently demand excusal, and emphasizing that "[b]ecause a plaintiff asserting a *Caremark* claim must plead facts sufficient to establish board involvement in conscious wrongdoing, our Supreme Court has admonished stockholders repeatedly to use Section 220 of the General Corporation Law, 8 Del. C. § 220, to obtain books and records and investigate their claims before filing suit"). Claims of improper accounting and financial reporting "most cr [y] out for the pleading of real facts - e.g. about the board's knowledge of the accounting problems at the company or the company's audit committee process"). Plaintiff's failure to follow this widely accepted procedure and comply with Delaware's exacting pleading requirements is fundamentally fatal to its derivative claim.

Conclusion

For the foregoing reasons, the court grants defendants' motion to dismiss with prejudice.

Accordingly, it is

ORDERED that motion to dismiss for defendants is granted; and it is further

ORDERED that the motion is granted with prejudice.

Dated: July 3, 2014

ENTER:

<<signature>>

J.S.C.

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15 Pa.C.S.A. § 8849.2
Formerly cited as PA ST 15 Pa.C.S.A. § 8946; PA ST 15 Pa.C.S.A. § 8947

§ 8849.2. Standards of conduct for managers

Effective: February 21, 2017
Currentness

(a) General rule.--A manager of a manager-managed limited liability company owes to the company and, subject to section 8881(b) (relating to direct action by member), the members the duties of loyalty and care stated under subsections (b) and (c).

(b) Duty of loyalty.--The fiduciary duty of loyalty of a manager in a manager-managed limited liability company includes the duties:

(1) to account to the company and to hold as trustee for it any property, profit or benefit derived by the manager:

(i) in the conduct or winding up of the company's activities and affairs;

(ii) from a use by the manager of the company's property; or

(iii) from the appropriation of a company opportunity;

(2) to refrain from dealing with the company in the conduct or winding up of the company's activities and affairs as or on behalf of a person having an interest adverse to the company; and

(3) to refrain from competing with the company in the conduct of the company's activities and affairs until completion of the winding up of the company.

(c) Duty of care.--The duty of care of a manager of a manager-managed limited liability company in the conduct or winding up of the company's activities and affairs is to refrain from engaging in gross negligence, recklessness, willful misconduct or knowing violation of law.

(d) Good faith and fair dealing.--A manager of a manager-managed limited liability company shall discharge the duties and obligations under this title or under the operating agreement and exercise any rights consistently with the contractual obligation of good faith and fair dealing.

(e) Ratification of breach of duty of loyalty.--All the members, or a majority of disinterested managers, of a manager-managed limited liability company may authorize or ratify, after disclosure of all material facts, a specific act or transaction by a manager that otherwise would violate the duty of loyalty.

(f) Fairness as a defense.--It is a defense to a claim under subsection (b)(2) and any comparable claim in equity or at common law that the transaction was fair to the limited liability company.

(g) Manager's rights in approved transaction.--If a manager enters into a transaction with the limited liability company which otherwise would be prohibited by subsection (b)(2), and the transaction is approved or ratified as provided by subsection (e) or the operating agreement, the manager's rights and obligations arising from the transaction are the same as those of a person that is not a manager.

(h) Exoneration.--The operating agreement may provide that a manager in a manager-managed limited liability company shall not be personally liable for monetary damages to the company or the members for a breach of subsection (c), except that a manager may not be exonerated for an act that constitutes recklessness, willful misconduct or a knowing violation of law.

(i) Cross reference.--See section 8815 (relating to contents of operating agreement).

Credits

2016, Nov. 21, P.L. 1328, No. 170, § 29, effective in 90 days [Feb. 21, 2017].

Editors' Notes

COMMENTS AND SOURCE NOTES

Committee Comment--2016

This section is patterned after Uniform Limited Liability Company Act (2006) (Last Amended 2013) § 409.

This section states some of the core aspects of the fiduciary duty of loyalty, provides a duty of care, and incorporates the contractual obligation of good faith and fair dealing. The duties stated in this section are subject to the operating agreement, but 15 Pa.C.S. § 8815(c) and (d) contain important limitations on the power of the operating agreement to affect fiduciary duties and the obligation of good faith and fair dealing.

Subsection (a)--This subsection recognizes two core managerial duties, but does not purport to exhaustively state all managerial duties. The reference to 15 Pa.C.S. § 8881(b) is needed because a

member may bring a direct action against a manager only if the member has standing as provided in that section.

Subsection (b)--This subsection states three core aspects of the fiduciary duty of loyalty: (i) not "usurping" company opportunities or otherwise wrongly benefiting from the company's operations or property; (ii) avoiding conflict of interests in dealing with the company (whether directly or on behalf of another); and (iii) refraining from competing with the company. Essentially the same duties exist in agency law and under the law of all types of business organizations.

Subsection (b) applies beginning with "the conduct ... of the company's activities and affairs;" thus the stated duties do not apply to pre-formation activities. In some circumstances, comparable duties might arise from other law, particular the law of agency. *See, e.g.*, 15 Pa.C.S. § 8841(a) and (b) (stating that the organizer acts "on behalf of" others).

The duties stated in subsection (b) are either partially or fully default rules. 15 Pa.C.S. § 8815(c)(12) provides that the aspects of the duty of loyalty stated in 15 Pa.C.S. § 8849.2(b)(1)(i) or (ii) or (2) may not be eliminated by the operating agreement, but Pa.C.S. § 8815(d)(3)(i) permits those aspects of the duty of loyalty to be altered if the alteration is not manifestly unreasonable. In contrast, there is no restriction on altering or eliminating the aspects of the duty of loyalty stated in 15 Pa.C.S. § 8849.2(b)(1)(iii) or (3).

Subsection (b)(1)--The phrase "hold as trustee" dates back to UPA (1914) § 21 and reflects the availability of disgorgement remedies, such as a constructive trust. In contrast to an actual trustee, a person subject to this duty does not: (i) face the special obstacles to consent characteristic of trust law; or (ii) enjoy protection for decisions taken in reliance on the governing instrument and other sources of information.

Subsection (b)(1)(i)--This provision is consistent with a basic principle of agency law-namely, that an agent may not benefit at all from the performance of the agency unless the principal consents. Restatement (Third) of Agency § 8.06, cmt. c. (2006). Typically, however, the operating agreement will legitimize particular benefits, *e.g.*, a management fee paid to a member-manager in addition to that person's share of distributions. Also, an agreed allocation of distributions takes those benefits outside the reach of this provision.

Subsection (b)(1)(ii)--In the context of this paragraph, the term "property" includes confidential information.

Subsection (b)(1)(iii)--Chapter 88 does not specify what constitutes "a company opportunity," but ample case law exists. *See, e.g.*, *Ebenezer United Methodist Church v. Riverwalk Development Phase, II, LLC,* 45 A.3d 883, 887 (Md.App. 2012) (discussing the "interest or reasonable expectancy test") and *In re McCook Metals, L.L.C.*, 319 B.R. 570, 596 (Bankr.N.D.Ill. 2005) (discussing the "line of business test"). In most, if not all, situations, usurping a company opportunity also breaches the duty not to compete. Subsection (b)(3), but not *vice versa*.

Subsection (b)(2)--In this context, the phrase "interest adverse" is a term of art, meaning "to be on the other side of the table" in some dealing with the limited liability company. Absent informed consent by the company, this duty is breached by the mere existence of the conflict of interest and the company need not prove that the outcome of the dealing was adverse to the company. *But see* subsection (f) (permitting the defense of fairness).

Subsection (b)(3)--Although competition is often thought of in terms of potential customers, this duty applies equally to competition for resources, including employees.

Subsection (c)--Neither this chapter nor Chapter 84 or 86 refer to the duty of care as a fiduciary duty, because: (i) the duty of care applies in many non-fiduciary situations; and (ii) breach of the duty of care is remediable in damages while breach of a fiduciary duty gives rise also to equitable remedies, including disgorgement, constructive trust, and rescission. That change in label is consistent with the Restatement (Third) of Agency § 8.02 (2006), which refers to the agent's "fiduciary duty to act loyally, but eschews the word 'fiduciary' when stating the agent's duties of 'care, competence, and diligence.' " *Id.* § 8.08. However, the change in label is merely semantics; no change in the law is intended.

The operating agreement can raise the standard of care, or subject to 15 Pa.C.S. § 8815(c)(12) and (d)(3)(iv), lower it. A person's practical exposure for breaching the duty of care involves not only the standard of care but also any operating agreement provision that: (i) exonerates the person from liability for breach of the duty of care; or (ii) entitles the person to indemnification despite the breach.

In discharging the duties required by this section, a manager may rely on other persons if the manager's conduct in so relying satisfies the duty of care required under subsection (c).

Subsection (d)--This subsection refers to the "*contractual* obligation of good faith and fair dealing" (emphasis added) and thereby invokes the implied obligation that exists in every contract. *See* Restatement (Second) of Contracts § 205 (1981) ("Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.")

At first glance, it may seem strange to apply a contractual obligation to statutory duties and rights-*i.e.*, duties and rights "under this title." However, for the most part those duties and rights apply to relationships *inter se* the members, managers, and the limited liability company and function only to the extent not displaced by the operating agreement. In the contract-based organization that is a limited liability company, those statutory default rules are intended to function like a contract. Therefore, applying the contractual notion of good faith and fair dealing makes sense.

The contractual obligation of "good faith" has nothing to do with the corporate concept of good faith that for years bedeviled courts and attorneys trying to understand: (i) Delaware's famous corporate law exoneration provision; and (ii) that provision's exception "for acts or omissions not in good faith." Del. Code Ann. tit. 8, § 102(b)(7) (2012). In that context, good faith is an aspect of the duty of loyalty. *See* ***Stone*** *ex rel. AmSouth Bancorp. v.* ***Ritter***, 911 A.2d 362, 369-70 (Del. 2006).

Likewise, the contractual obligation of good faith and fair dealing has nothing to do with the "utmost good faith" sometimes used to describe the fiduciary duties that owners of closely held businesses owe each other. *See e.g. Meinhard v. Salmon*, 164 N.E. 545, 551 (N.Y. 1928) ("[W]here parties engage in a joint enterprise each owes to the other the duty of the utmost good faith in all that relates to their common venture. Within its scope they stand in a fiduciary relationship."); *Donahue v. Rodd Electrotype Co. of New England, Inc.*, 328 N.E.2d 505, 515 (Mass. 1975) ("[S]tockholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another. In our previous decisions,

we have defined the standard of duty owed by partners to one another as the utmost good faith and loyalty." (footnotes, citations, and internal quotations omitted)).

To the contrary, the contractual obligation of good faith and fair dealing is not a fiduciary duty, does not command altruism or self-abnegation, and does not prevent a member from acting in the member's own self-interest:

> "Fair dealing" is not akin to the fair process component of entire fairness, i.e., whether the fiduciary acted fairly when engaging in the challenged transaction as measured by duties of loyalty and care .. It is rather a commitment to deal "fairly" in the sense of consistently with the terms of the parties' agreement and its purpose. Likewise "good faith" does not envision loyalty to the contractual counterparty, but rather faithfulness to the scope, purpose, and terms of the parties' contract. Both necessarily turn on the contract itself and what the parties would have agreed upon had the issue arisen when they were bargaining originally.

Gerber v. Enter. Products Holdings, LLC, 67 A.3d 400, 418-19 (Del. 2013) (quoting *ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, LLC*, 50 A.3d 434, 440-42 (Del. Ch. 2012), *aff'd in part, rev'd in part on other grounds*, 68 A.3d 665 (Del. 2013)) (footnotes, citations, and internal quotations omitted without ellipsis by *Gerber*). *See also* 15 Pa.C.S. § 8849.2(e).

Courts should not use the contractual obligation to change *ex post facto* the parties' or this chapter's allocation of risk and power. To the contrary, the obligation should be used only to protect agreed-upon arrangements from conduct that is manifestly beyond what a reasonable person could have contemplated when the arrangements were made.

The operating agreement or this chapter may grant discretion to a manager, and the contractual obligation of good faith and fair dealing is especially salient when discretion is at issue. However, a manager may properly exercise discretion even though a member suffers as a consequence. Conduct does not violate the obligation of good faith and fair dealing merely because that conduct substantially prejudices a party. Indeed, parties allocate risk precisely because prejudice may occur.

The exercise of discretion constitutes a breach of the obligation of good faith and fair dealing only when the party claiming breach shows that the conduct has no honestly-held purpose that legitimately comports with the parties' agreed-upon arrangements:

> An implied covenant claim ... looks to the past. It is not a free-floating duty unattached to the underlying legal documents. It does not ask what duty the law should impose on the parties given their relationship at the time of the wrong, but *rather what the parties would have agreed to themselves had they considered the issue in their original bargaining positions at the time of contracting*.

Gerber v. Enter. Prods. Holdings, LLC, 67 A.3d 400, 418 (Del. 2013) (quoting *ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, LLC*, 50 A.3d 434, 440-42 (Del. Ch. 2012), *aff'd in part, rev'd in part on other grounds*, 68 A.3d 665 (Del. 2013)) (emphasis added, footnotes, citations, and internal quotations omitted by *Gerber*).

In sum, the purpose of the contractual obligation of good faith and fair dealing is to protect the arrangement the partners have chosen for themselves, not to restructure that arrangement under the guise of safeguarding it.

As to the power of the operating agreement to affect the contractual obligation of good faith and fair dealing, see 15 Pa.C.S. § 8815(c)(13) (prohibiting elimination but allowing the agreement to "prescribe standards, if not manifestly unreasonable, by which the performance of the obligation is to be measured"). As to whether the obligation stated in this subsection applies to transferees, *see* the Committee Comment to 15 Pa.C.S. § 8817(b).

Subsection (f)--The operating agreement can provide additional or different methods of authorization or ratification, subject to the strictures of 15 Pa.C.S. § 8815(c)(12) and (d), and (d).

Subsection (g)--This subsection is the modern, reformulated version of a language that sought to overturn the now-defunct notion that debts to partners were categorically inferior to debts to non-partner creditors. The reformulation makes clear that this provision does not override the obligation to avoid conflict of interests.

Subsection (h)--This subsection merely negates a claim of fiduciary duty that is exclusively status-based and does not immunize misconduct.

EXAMPLE: Although a limited liability company is manager-managed, one member who is not a manager owns a controlling interest and effectively, albeit indirectly, controls the company's activities. A member owning a minority interest brings an action for dissolution under 15 Pa.C.S. § 8871(a)(4)(iii)(B) (oppression by "the managers or those members in control of the company"). This paragraph does not prevent the court from construing the claim as alleging a breach of fiduciary duty by the controlling member.

The following terms used in this section are defined in 15 Pa.C.S. § 8812:

"limited liability company"

"manager"

"manager-managed limited liability company"

"member"

"operating agreement"

15 Pa.C.S.A. § 8849.2, PA ST 15 Pa.C.S.A. § 8849.2
Current through 2019 Regular Session Act 3. Some statute sections may be more current, see credits for details.

End of Document

9 NYCRR 4.92

Section 4.92. Executive Order No. 92: Designating Acting Supreme Court Justice Marie G. Santagata to hold an Extraordinary Special and Trial Term of the Supreme Court in the County of New York, in place of Justice David S. **Ritter***

* [Revoked by Executive Order No. 31 (George E. Pataki), *infra.*]

* [Revoked by Executive Order No. 5 (Eliot Spitzer), *infra.*] [Revoked by Executive Order No. 9 (David A. Paterson), *infra.*] [Revoked by Executive Order No. 2 (Andrew M. Cuomo), *infra.*]

WHEREAS, By an Order dated the twenty-seventh day of March, nineteen hundred eighty-six, an Extraordinary Special and Trial Term of the Supreme Court in the County of New York was appointed for the purpose of prosecution and trial of the indictment, or any amendments thereto, heretofore filed in the County of New York against Marvin B. Kaplan, Albert J. Kaplan, Stanley Friedman, Marvin H. Kushnick and E. Martin Solomon, and for the purpose of conducting such other and further proceedings as may be necessary or incidental to such trial or trials, and such other proper matters as may come before the Court; and

WHEREAS, By Order dated the twenty-seventh day of March, nineteen hundred eighty-six, the Honorable David S. **Ritter**, a Justice of the Supreme Court of the State of New York, Ninth Judicial District, was designated to hold said Extraordinary Special and Trial Term of the Supreme Court; and

WHEREAS, The designation of the Honorable David S. **Ritter** is terminated, at his request, based on compelling personal family reasons presented by said Honorable Justice:

NOW, THEREFORE, I, Mario M. Cuomo, Governor of the State of New York, it appearing to my satisfaction that the public interest requires it, and in accordance with article VI, section 27 of the Constitution, statute and law in such case made and provided, by virtue of the authority vested in me by the Constitution and laws of the State of New York, I do hereby designate the Honorable Marie G. Santagata, a Judge of the New York State Court of Claims, to hold the said Extraordinary Special and Trial Term in the County of New York, in the place and stead of the Honorable David S. **Ritter**.

I do further direct that copies of the notice of designation hereinabove made and provided for shall be released and distributed to the general press.

Signed: Mario M. Cuomo

Dated: March 31, 1987

Credits

Order dated March 31, 1987, filed April 1, 1987.

[FN1]

Executive Orders bearing numbers like 55.43, etc, denoting amendments to Governor Rockefeller's orders numbered 55 through 59, are the so-called ”New York City superseders” and are appended to the Executive Orders in Part 1 of this Title.

Current with amendments included in the New York State Register, Volume XXLI, Issue 19 dated May 8, 2019. Court rules under Title 22 may be more current.

9 NYCRR 4.92, 9 NY ADC 4.92

End of Document

1982 WL 155759 (Mo.Lab.Ind.Rel.Com.)

Labor and Industrial Relations Commission

State of Missouri

EMPLOYEE: WILLIAM C. **STONE**, SR.
EMPLOYER: PROCTOR AND GAMBLE PAPER PRODUCTS COMPANY
INSURER: SELF-INSURER
ADDITIONAL PARTY: TREASURER OF MISSOURI AS CUSTODIAN OF SECOND INJURY FUND

Injury No. 79–148569
May 3, 1982

***1** Date of Accident: October 10, 1979

Place and County of Accident: Cape Girardeau Cape Girardeau County, Missouri

FINAL AWARD ALLOWING COMPENSATION

(Affirming Award of Administrative Law Judge)

The above-entitled workers' compensation case is submitted to the Labor and Industrial Relations Commission for review as provided by Section 287.480 Revised Statutes of Missouri. The Commission, after having reviewed the evidence and considered the whole record, finds that the award of the administrative law judge herein is supported by competent and substantial evidence, and was made in accordance with the Missouri Workers' Compensation Act; and, therefore, the Commission, pursuant to Section 286.090 Revised Statutes of Missouri, hereby affirms the award of the administrative law judge dated February 25, 1981.

The Commission further approves and affirms said administrative law judge's allowance of attorney's fee herein as being fair and reasonable. Any past due compensation shall bear interest at the rate of six percent per annum until August 13, 1980 and at a rate of eight percent per annum thereafter as provided by Section 287.160 Revised Statutes of Missouri.

The award of Administrative Law Judge Edwin F. Ragland issued February 25, 1981 attached hereto is made a part hereof for all purposes.

Given at Jefferson City, State of Missouri, this ord day of May 1982.

Terry C. Allen
Chairman
Herbert L. Ford
Member
William F. Ringer
Member

Division of Workers' Compensation

Department of Labor and Industrial Relations of Missouri

AWARD ON HEARING

The above parties having submitted their disagreement or claim for compensation for the above accident to the undersigned Referee of the Division of Workmen's Compensation, and after hearing the parties at issue, their representatives, witnesses and evidence, the undersigned finds and awards compensation for said accident in favor of the above employee and against the above employer and insurer as provided in the Missouri Workmen's Compensation Law, as follows:
For Medical Aid ___ the sum of $ 60.65

For Healing Period ___ the sum of $ ___ per week for ___ weeks.

For Permanent partial disability the sum of $ 90.00 per week for 60 weeks.

For Liability of Second Injury Fund the sum of $ 90.00

For per week for 13.33 weeks. a lump sum of $ ___

said payments to begin October 11, 1979 and to be payable and be subject to modification and review as provided in said Law.

Albert C. Lowes, Attorney at Law, is hereby allowed a fee of 25% of the money award hereunder for necessary legal services rendered employee and said fee shall constitute a lien on said compensation.

Past due compensation shall bear interest at the rate of 8% per annum from date of this award as provided by Section 287.160(2) RSMo.

***2** Attached hereto are the Findings of Fact and Rulings of Law made in connection herewith.

Given at the City of Jefferson, State of Missouri, this 25th day of February, 1981

Edwin F. Ragland
Chief Administrative Law Judge

FINDINGS OF FACT

1. Was there an accident Yes 2. Date: October 10, 1979 3. Place: Cape Girardeau, Mo.

4. Was above employee in employ of above employer at time of accident? Yes

5. Did accident arise out of and in the course of the employment? Yes

6. At time of accident had employer elected to accept the Law? Yes 7. Employee? Yes

8. Was claim for compensation filed within time required by Law? Yes

9. What part of employer's compensation liability for accident is insured by above insurer? Total Self-Insurer

10. Work employee was doing and how accident happened: Employee suddenly dropped lift from fork, injuring back.

11. Did accident cause death? No (If so, see findings 26 and 27.)

12. Parts of body injured by accident: Back and body as a whole.

13. Exact nature of any permanent injury: 15% permanent partial disability to back and body as a whole.

13a. Healing period ___ weeks

14. Temporary total disability to date: ___ weeks. 15. Probable in future: ___ weeks.

16. Temporary partial disability to date: ___ weeks. 17. Probable in future: ___ weeks.

18. Employee's average weekly wages: $ Max.. 19. Weekly compensation, $125.00/$90.00.

20. Method wage computation: By agreement

COMPENSATION PAYABLE

21. Value necessary medical aid not furnished by employer or insurer ___	$ 60.65
22. Amount of compensation payable.	
For permanent partial disability: 60 wks. @$90.00 per wk.	5.400.00
Second Injury Fund: 13.33 weeks @$90.00 per week.	1,200.00
Total	$6,660.65
23. PAID TO DATE by employer or ___	$ ___
24. Balance payable employee or ___	$6,660.65

25. Probable future requirements:

26. Date of death ___

27. Employee's dependents, including those who could be dependents if widow dies or re-marries:

FINDINGS OF FACT and RULINGS OF LAW:

The issues are:

(1) Nature and extent of disability, (a) permanent partial;

(2) Responsibility for medical aid;

(3) Medical causal relationship; and,

(4) Liability of Second Injury Fund.

The parties stipulated as follows:

Report of Ralph J. Graff, M.D. may be used in evidence in lieu of testimony; rate of compensation $125.00/ $90.00; temporary total disability paid by employer, $1,166.00 for 9 2/7 weeks @$125.00 per week; and, medical aid furnished in the sum of $601.03.

William C. **Stone**, Sr., employee, was employed by Procter and Gamble Paper Products Company on January 29, 1979 as a case packer, millhouse worker and front-end loader. All of his medical expenses in connection with his accident of October 10, 1979 have been paid except three prescriptions which total $26.65. On the above date employee was operating a forklift truck which he thought was going to overturn. As he dropped the lift suddenly, he injured his back requiring treatment from Dr. Campbell, Dr. Burford and Dr. Otto, all of Cape Girardeau, Missouri.

***3** Mr. **Stone** suffered from osteomyelitis as a child which caused some problems with his right leg until 1951. After treatment at Firmin Desloge Hospital, St. Louis, Missouri, he was able to function with limited bending to his right knee, wore a 'lift in his shoe' but otherwise was in good health. He has spent $34.00 for additional height applied to his right footwear as suggested by Dr. Otto.

Employee presently complains of pain in his back for which he takes medication consisting of pain relievers and muscle relaxants. He is unable to lift heavy objects and has difficulty stooping or bending but is able to hold down a full-time job as a welding instructor of the Vocational Education School at Perryville, Missouri.

Dr. Thomas G. Otto, M.D., orthopedic surgeon, Cape Girardeau, Missouri, testified by deposition on behalf of employee (Claimant's Exhibit B), and stated that he first saw employee on January 11, 1980, with complaints of low back pain without leg pain as a result of an incident while working at the Procter and Gamble plant when a forklift truck he was driving started to tip and he released the load quickly, jarring himself. He missed ten days, returned to work and worked with pain until December 31, 1979, at which time he stopped work. He gave a further history of a bone infection called osteomyelitis in the right leg at the right knee area as a child, later developed valgus or knock-knee of the right knee, and as a result subsequently developed about two inches of shortening in his right leg.

Physical examination elicited complaints of pain in the left paralumbar area at the L–5, S–1 level. Other tests were within normal limits with the exception of the shortened right leg. X-rays taken by Shoss Radiological Clinic were reviewed and showed minor degenerative osteoarthritic changes.

Diagnosis was that the pain was due to stress/strain at the lower back level associated with scoliosis developed because of the shortening of the right leg. Additional elevation on his shoe was prescribed as well as an additional period of rest, and continuing to wear his corset.

It is the doctor's opinion that the stress/strain in the lumbar area in connection with the scoliosis and shortening of his leg continued to aggrevate his complete recovery and has initiated and aggrevated pain in the low back area that is permanent, estimated at 20 (14–1/2) percent to the body as a whole as a result of the strain. Disability to the right leg alone at the hip level of 207 weeks level is 30 percent. Disability for his

working ability overall is estimated at about fifty percent to the body as a whole, therefore thirty percent would pre-exist the October, 1979 back strain.

Dr. R. A. **Ritter**, orthopedic surgeon, Cape Girardeau, Missouri, testified by deposition on behalf of employee (Claimant's Exhibit A) and stated that based on his examination of March 26, 1980, he feels employee has sustained a severe sprain in his back superimposed on pre-existing scoliosis incident to the shortening of his right leg which now renders him incapable of performing heavy duty in the line of manual work.

***4** Permanent partial disability is rated at 30 percent of the body as a whole. If there had not been pre-existing osteomyelitis and deformity of his back and leg, disability from the injury alone would have been 10 percent of the body as a whole.

Dr. Ralph J. Graff's medical report dated November 10, 1980 was submitted by the Second Injury Fund and on behalf of the employer. Dr. Graff concluded: 'Taking into consideration the objective findings and subjective complaints, it is my opinion Mr. **Stone** has a 35 percent permanent partial disability between the right hip and right knee as a result of his osteomyelitis. It is my opinion that he has a 7.5 percent permanent partial disability of the man as a whole as a result of his back injury of October, 1979.'

Dr. Graff found no cumulative effect as a result of the two injuries.

(1) Disability; (a) permanent partial:

Based on lay testimony and expert medical evidence as set forth above, I find employee has sustained 15% permanent partial disability to his back and body as a whole as a result of his accidental injury of October 10, 1979 with Procter and Gamble, and is therefore entitled to 60 weeks of compensation at a rate of $90.00 per week for a total sum of $5,400.00.

(2) Medical aid:

I further find it was necessary for employee to obtain medical treatment not furnished by employer to cure and relieve him from the effects of the accidental injury with Procter and Gamble, consisting of three prescriptions in the sum of $26.65 and medically necessary shoe lifts in the sum of $34.00, which amounts have been paid by employee.

Employer is hereby directed to reimburse employee $60.64, which sum is fair and reasonable.

(3) Medical causal relationship:

Based on the medical evidence of R. A. **Ritter**, Sr., T. G. Otto and Ralph J. Graff, medical doctors, I find employee's physical disability to his back and body as a whole was caused and precipitated by his accidental injury of October 10, 1979 with Procter and Gamble.

(4) Second Injury Fund Disability:

I further find employee suffered from osteomyelitis as a child which resulted in a 35% industrially disabling disability to his right leg between the hip and knee which is equal to 56 weeks (160x35=56); and as a result of his accidental injury of October 10, 1979, substained 60 weeks of disability (Finding 1–a), which sums combined exceeds the total by 13.33 weeks applicable to the body as a whole as provided by Section

287.220(1) RSMo., and therefore employee is entitled to additional compensation from the Second Injury Fund of 13.33 weeks at a rate of $90.00 per week for a total sum of $1,200.00.

Date February 25, 1981

Edwin Ragland
Chief *Administrative Law Judge*

1982 WL 155759 (Mo.Lab.Ind.Rel.Com.)

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Fiduciary Duties of the Board of Directors

BY PRACTICAL LAW CORPORATE & SECURITIES

A Practice Note describing the fiduciary duties of the board of directors, including the core duties of care and loyalty, and the standards of review that courts apply when judging directors' conduct.

When stockholders invest in a corporation, they entrust their capital to the corporation's directors. But while it is the stockholders' investment that is at risk, it is a "cardinal precept" of Delaware corporate law (and of many other jurisdictions) that the business and affairs of the corporation are managed by its directors, not its stockholders (*Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984), overruled on other grounds by *Brehm v. Eisner*, 746 A.2d 244, 253-54 (Del. 2000)). Through this arrangement, the directors act as agents for the stockholders. For that reason, directors are charged with fiduciary duties to protect the interests of the corporation and to act in the stockholders' best interests.

This Practice Note describes the fiduciary duties of the board of directors under Delaware law. The Note focuses on Delaware law because:

- Delaware is a leading jurisdiction of incorporation, with a majority of all US public companies incorporated in Delaware.
- Delaware's law on fiduciary duties is well established and widely followed in other jurisdictions.

For information on how fiduciary duties are applied in other states, see Corporation Law: State Q&A Tool: Question 5.

This Note does not address the corporate governance requirements for public companies under the rules of the **SEC** and various stock exchanges. For more information on the obligations of directors under those regimes, see Practice Notes, Corporate Governance Standards: Board of Directors and Periodic Reporting and Disclosure Obligations: Overview.

Legal Framework

Under Delaware law, corporate acts are reviewed for their compliance with two sets of rules:

- The technical rules of the "corporate contract" between the directors and stockholders that address the legality of the act taken by the corporation.
- An overlay of equitable rules to ensure that otherwise legal acts are taken in compliance with the board's fiduciary duties to the corporation and its stockholders.

Delaware courts call this review the twice-testing principle (*Sample v. Morgan*, 914 A.2d 647, 673 (Del. Ch. 2007); *Carsanaro v. Bloodhound Techs., Inc.*, 65 A.3d 618, 641 (Del. Ch. 2013)).

There are three primary components of the corporate contract:

- The corporate statute of the state in which the corporation is incorporated. In Delaware's case, this is the **Delaware General Corporation Law** (DGCL). The majority of other states base their legislation on Delaware law or on the Model Business Corporations Act (MBCA).
- The corporation's articles or certificate of incorporation (often referred to as the charter).
- The corporation's by-laws.

These three sources comprise a hierarchy. A by-law that conflicts with the charter is void and a charter provision that conflicts with the statute is void (*Sinchareonkul v. Fahnemann*, 2015 WL 292314, at *6 (Del. Ch. Jan. 22, 2015)).

The rules governing directors' fiduciary duties stem from decades-old, yet continuously evolving, common law. (Fiduciary duties are codified in some states statutes, but remain a product of common law in Delaware.) Combining the two bodies of law, the Delaware courts on an ongoing basis interpret the statute and language in subject corporations' **organizational documents**, evaluate the context surrounding any alleged misconduct, and apply a standard of review based on prior precedent.

Role of Directors in Management of the Corporation

The ultimate responsibility for the business and affairs of the corporation belongs to the board of directors. This power is codified in Section 141(a) of the DGCL and by similar statutes in other states. The board discharges this responsibility by:

- Appointing officers who run the day-to-day operations of the corporation, propose strategies and objectives, and implement corporate plans.
- Supervising those officers.
- Making major decisions for the corporation (for example, selling the company or entering into a significant joint venture).

The stockholders of the corporation, by contrast, have two fundamental rights:

- To elect directors to the board.
- To exit the corporation by selling their shares.

The stockholders themselves do not manage the corporation. Even a majority stockholder who has the voting power to replace the directors—though it also owes fiduciary duties to the other stockholders (see Who Owes Duties to Whom)—does not manage the corporation. To illustrate, the Delaware Court of Chancery ruled that stockholders cannot amend the corporation's by-laws to give them the right to appoint officers, even if they have the votes to do so, since that right is reserved to the board and the stockholders do not have the right to manage the corporation (*Gorman v. Salamone*, 2015 WL 4719681, at *5 (Del. Ch. July 31, 2015)).

Stockholders can have special rights such as **dividend** payments, veto rights, consents, and other rights that can be provided for contractually in the certificate of incorporation or in a stockholders agreement. But these rights must be specifically negotiated; they are not automatically available as a matter of law.

Delegation

Directors are often selected for their expertise in a particular area or for their industry connections and are added to the board to fulfill an advisory or supervisory role within their area of focus. To facilitate this, state statutory law permits, and corporate charters typically authorize, the board to delegate any of its powers to a committee of directors. However, many state statutes restrict the scope of the activities that can be conducted by a committee of less than an entire board.

Board committees have significant power under Delaware law. A duly appointed committee (such as a compensation or nominating committee) holds all powers delegated to it by the full board (or as otherwise

provided for in the certificate of incorporation or by-laws), other than the power to:

- Approve, adopt or recommend to the stockholders any action or matter (other than the election or removal of directors) expressly required by Delaware law to be approved by the stockholders.
- Adopt, amend, or repeal any of the corporation's by-laws.

(8 Del. C. § 141(c)(2).)

By delegating powers to committees, the other members of the board benefit themselves as well. Directors are also explicitly protected from liability when they reasonably rely in good faith on reports from committees, officers, and other experts when making decisions for the corporation (8 Del. C. § 141(e)). For further discussion of the advantages of forming committees, see Practice Note, Making Good Use of Special Committees: The Advantages of Using a Special Committee.

Core Fiduciary Duties

Directors owe two core fiduciary duties:

- The duty of care, which requires that directors be fully and adequately informed and act with care when making decisions and acting for the corporation (see Duty of Care).
- The duty of loyalty, which requires that directors act and make decisions in the best interest of the corporation, not in their own personal interest (see Duty of Loyalty).

Courts and practitioners frequently refer to other duties, such as the duty of good faith, the duty of disclosure, and the duty of oversight. This nomenclature implies that these are standalone fiduciary duties, and in some states the duty of good faith is analyzed as a separate duty. Under Delaware law, they are treated as obligations that stem from the core fiduciary duties of care and loyalty.

Who Owes Duties to Whom

Directors owe their fiduciary duties to the corporation and its stockholders (*Arnold v. Soc'y for Sav. Bancorp, Inc.*, 678 A.2d 533, 539 (Del. 1996)). Certain states (for example, Pennsylvania) contain constituency statutes that explicitly allow the board of directors to consider the interests of constituencies other than the stockholders, including employees, customers, suppliers, and creditors. The DGCL contains no such provision.

The corporation itself does not owe fiduciary duties to the stockholders and, similarly, cannot be held to have aided or abetted any breaches by the directors of their duties (see *Arnold v. Soc'y for Sav. Bancorp, Inc.*, 678 A.2d 533, 539 (Del. 1996); *Buttonwood True Value P'rs, L.P. v. R.L. Polk & Co., Inc.*, 2014 WL 3954987 (Del. Ch. Aug. 7, 2014)).

Under ordinary circumstances, the board owes fiduciary duties to the preferred and common stockholders equally. However, if the interests of the preferred and common stockholders diverge, the board owes its fiduciary duties exclusively to the common stockholders (see *In re Trados Inc. S'holder Litig.*, 2009 WL 2225958 (Del. Ch. July 24, 2009)). The rights of the preferred stockholders are then governed by the terms of the **certificate of designation** under which the **preferred stock** was issued.

If the corporation is **insolvent**, directors continue to owe fiduciary duties to the corporation, but the corporation's creditors replace the stockholders as the primary beneficiaries of those duties (see Insolvency). Creditors of solvent corporations are generally protected by the contract and by debtor-creditor law, not by corporate law binding the directors.

A controlling stockholder owes fiduciary duties to the corporation and minority stockholders if it owns a majority interest in or exercises control over the affairs of the corporation (*Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1114 (Del. 1994); for discussion of the test for control, see Defining Control for Entire Fairness).

Officers of Delaware corporations owe the same fiduciary duties of care and loyalty as directors owe (*Gantler v. Stephens*, 965 A.2d 695, 709 (Del. 2009)). For a detailed discussion of officers' duties and the standard of review of their conduct under Delaware law, see Practice Note, Fiduciary Duties of Officers of Corporations.

Insolvency

Directors have a duty to the corporation and its stockholders. Under Delaware law, this duty does not typically extend to other constituencies such as bond holders and other creditors because they are protected by contract or other statutory schemes (such as state commercial laws). However, as a corporation approaches insolvency, the creditors start to resemble equity holders in that they may ultimately have the final claim on the corporation's assets. At that point, creditors arguably hold the interest in maximizing the value of the corporation that is ordinarily held by the common stockholders. Some courts have indicated that a director's fiduciary duties might shift at this point to the creditors.

The Delaware Supreme Court addressed this question in the *Gheewalla* case (see *N. Am. Catholic Educ. Programming Found. Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007)). The court decided that creditors of a corporation have no right to assert **direct claims** against directors for breach of fiduciary duty. This remains the case whether the corporation is merely approaching insolvency (referred to as the zone of insolvency) or already insolvent. The court rationalized that creditors should continue to be protected by contracts, commercial laws (such as the covenant of good faith and fair dealing) and bankruptcy laws. When a corporation falls into the zone of insolvency, directors should not be hindered by the threat of fiduciary duty lawsuits when negotiating with creditors. However, creditors hold standing to bring a **derivative claim** for any breaches of fiduciary duty on behalf of the corporation once a corporation becomes insolvent (see also *Quadrant Structured Prod. Co., Ltd. v. Vertin*, 2014 WL 5099428, at *10 (Del. Ch. Oct. 1, 2014)).

For more information on the fiduciary duties of directors of distressed or insolvent companies, see Practice Note, Fiduciary Duties of Directors of Financially Troubled Corporations.

Duty of Care

A director must follow the duty of care when making decisions or acting on behalf of the corporation. Most states have codified the duty of care, generally following the standards of the MBCA. The MBCA requires a director to act with the care that a person in a like position would reasonably believe appropriate under similar circumstances. For example, both California and New York have codified the duty of care and closely follow the MBCA with minor modifications:

- The California statute requires a director to act in good faith, in a manner the director believes to be in the best interests of the corporation and its stockholders, and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances (see California Corporation Code § 309(a) and Corporation Law: California: State Q&A).
- The New York statute requires a director to perform his duties in good faith and with the degree of care which an ordinarily prudent person in a like position would use under similar circumstances (see N.Y. Bus. Corp. § 717(a)).

While not codified in Delaware, the duty of care has been developed in case law along similar lines. Delaware courts generally describe the duty of care as the obligation to use the amount of care which an ordinarily careful and prudent person would use in similar circumstances. A director also breaches his duty of care if he takes no action in a situation where a careful person would have taken action. For example, if a corporation commits securities fraud, a director can be held liable for failing to stop the fraud if he failed to attend any meetings, monitor management in any way, or otherwise take action (see Duty of Oversight).

This formulation of the duty of care implies that directors' decisions are always scrutinized for their reasonableness. However, Delaware courts recognize that directors sometimes must take business risks to

promote the best interests of the corporation and its stockholders, and that judges and stockholders are not in the best position to second-guess business decisions made by the board of directors. Judges have been particularly careful not to impose liability for a decision that seems wrong only with the benefit of hindsight. To allow boards to take necessary business risks and to attract qualified people to serve as directors, Delaware has adopted the following:

- **The business judgment rule.** The business judgment rule presumes that directors comply with the duty of care and imposes liability only for breaches committed with gross negligence (see Business Judgment Rule).
- **Statutory limitation of liability.** Most states allow the corporation's certificate of incorporation to eliminate or limit directors' personal liability for money damages to the corporation or its stockholders for breach of their duty of care. Delaware provides for this exculpation in Section 102(b)(7) of the DGCL. The statute allows corporations to exculpate its directors for breaches of their fiduciary duties, barring breaches committed in bad faith or under circumstances of conflict of interest, both of which invoke the duty of loyalty.
- **Indemnification.** **Indemnification** statutes protect directors from liability stemming from their service to the corporation. Section 145 of the DGCL requires a corporation to indemnify a person who was made a party to a proceeding by reason of his service to the corporation and who has achieved success, on the merits or otherwise, in that proceeding. The corporation is also authorized to advance expenses to directors if the director acts in good faith and in the best interests of the corporation and has no reasonable cause to believe that his behavior was unlawful.
- **Insurance.** Delaware law permits corporations to insure directors to cover losses (such as settlement costs, fines and legal fees) resulting from a breach of the duty of care. Companies can purchase this insurance, known as Director and Officer Insurance (or **D&O Insurance**). Insurance to protect directors from fraud, dishonesty or for violations of criminal law cannot be purchased (see Section 145 of the DGCL and Practice Note, Directors and Officers Liability Insurance Policies).

The duty of care does not prescribe any particular actions that the board must take. Of particular note, directors have no *per se* duty to maximize the profits of the corporation. Directors can take actions that do not directly increase the corporation's profits (for example, cause the corporation to make charitable donations), as long as there is a connection to a rational business purpose. The board cannot be held liable for making a business decision simply because another decision would have been more profitable for the corporation.

To illustrate a consequence of this principle, the Delaware judiciary has repeatedly ruled that a board has no fiduciary duty to minimize corporate taxes (see *Freedman* ***v****. Adams*, 58 A.3d 414, 417 (Del. 2013): "The decision to sacrifice some tax savings in order to retain flexibility in compensation decisions is a classic exercise of business judgment"; *Seinfeld* ***v****. Slager*, 2012 WL 2501105, at *3 (Del. Ch. June 29, 2012): "Delaware law is clear that there is no separate duty to minimize taxes, and a failure to do so is not automatically a waste of corporate assets").

Duty of Loyalty

The duty of loyalty requires directors to act in good faith for the benefit of the corporation and its stockholders, not for their own personal interests. The duty of loyalty embodies not only an affirmative duty to protect the interests of the corporation—which is the purpose of the duty of care—but also an obligation to refrain from conduct that would harm the corporation and its stockholders.

Breaches of the duty of loyalty are treated more seriously than breaches of the duty of care in terms of both the initial standard of review and the consequences of a breach. Decisions or transactions involving a conflict of interest are not protected by the business judgment rule, and the statutory limitation of liability under Section 102(b)(7) of the DGCL is not available. If the directors hold a personal interest in an action, the court will not presume they acted in the best interest of the corporation.

Corporate Opportunity Doctrine

One way in which the duty of loyalty may be breached is if a director or officer usurps a corporate opportunity. Courts analyze several factors to determine whether a corporate opportunity rightfully belongs to the corporation. In Delaware, these factors include:

- If the opportunity is in the same line of business as the corporation's.
- Whether the corporation has an interest or expectancy in the opportunity.
- Whether the corporation would be financially able to take the opportunity had it been presented. (This factor is met if the usurper had a parallel contractual obligation to present corporate opportunities to the corporation (*Yiannatsis v. Stephanis ex re. Sterianou*, 653 A.2d 275, 279 (Del. 1995)).
- Whether taking the opportunity would create a conflict of interest or be a breach of fiduciary duties for the director or officer.

Section 122(17) of the DGCL allows corporations to renounce expectations to any specified business opportunities or specified classes or categories of business opportunities.

Standards of Review

The decisions and actions taken by the board of directors, together with the possibility that the directors may have breached a fiduciary duty, are evaluated under one of three standards of review:

- The business judgment rule, which applies to decisions made by directors who are disinterested and independent.
- The entire fairness standard, which applies in situations of actual conflict of interest, and which is the most onerous standard of review under Delaware law.
- An intermediate standard of enhanced scrutiny, which applies in recognized situations of potential conflict of interest.

A court's decision on breach and liability often resolves itself on the basis of the initial decision of which standard of review to apply. If the directors demonstrate that they are entitled to the presumptions of the business judgment rule, it is a virtual certainty that the court will rule in the directors' favor on any question of breach. By contrast, transactions that must be reviewed for their entire fairness are the most common source for findings of breach of fiduciary duties.

Business Judgment Rule

Courts are loathe to substitute their business judgment for the directors' or to question business decisions with the benefit of hindsight, unless the decision of the board cannot be attributed to any rational business purpose (*Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971)). For this reason, directors' actions are protected by the presumptions of the business judgment rule. The rule presumes that 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. In a lawsuit alleging a breach of the duty of care, the court makes this presumption unless the plaintiff can show that a majority of the directors did not meet the following three elements:

- **Stay informed.** Directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them (*Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985)). In this regard, counsel should advise directors to participate in board actions. For directors to establish that they kept themselves informed of the corporation's business and the issues brought to the board, they should attend meetings (in person or by phone), carefully read reports or other materials prepared for the board, and ask questions at meetings. Directors can rely on information and opinions from consultants, management, and employees, but they must make a good-faith determination that those persons can

competently produce the reports and make the analyses 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.

- **Act in good faith.** The directors must act in good faith. The decision-making process must be substantive and cannot just rubber-stamp management's actions. Delaware courts frequently define good faith as the absence of bad faith. For a discussion of how a plaintiff would establish bad faith, see Duty of Good Faith.
- **Take action in the best interest of the corporation.** The directors must reasonably believe the action or transaction was made in the best interest of the corporation. If a majority of the board has a conflict of interest in the underlying action, the conflicted directors are not entitled to the presumptions of the business judgment rule (*Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).

If a majority of the board qualifies for the presumptions of the business judgment rule, the standard for a finding of a breach of the duty of care is gross negligence (see *In re Citigroup Inc. S'holder Deriv. Litig.*, 964 A.2d 106, 124 (Del. Ch. 2009), citing *Aronson v. Lewis*, 473 A.2d at 812). Even if a plaintiff chooses to file a claim for breach of fiduciary duties against only one director, the plaintiff still must rebut the presumptions of the business judgment rule as to a majority of the directors to succeed on its claim against the individual (*Hamilton P'rs, L.P. v. Highland Capital Mgmt., L.P.*, 2014 WL 1478511 (Del. Ch. May 7, 2014)). If, as is common, the company's certificate of incorporation exculpates directors for breaches of the duty of care, as is authorized under Section 102(b)(7) of the DGCL, liability must be premised on a finding of a breach of the duty of loyalty.

Corporate Waste

If the plaintiff fails to rebut the presumption of the business judgment rule (because a majority of the directors were disinterested and independent) and cannot demonstrate a breach of a duty (because the directors did not act with gross negligence or bad faith), the plaintiff will not be entitled to any remedy unless the challenged transaction constitutes waste.

To recover on a claim of waste, a plaintiff must prove that the relevant exchange was "so one-sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration" (*In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 74 (Del. 2006)). This is considered a stringent standard that, under *Disney*, is only met in the "rare, unconscionable case where directors irrationally squander or give away corporate assets." For example, spending on items such as employee vehicles, outings, social-club dues, and holiday gifts is usually attributable to a rational business purpose and typically does not support a finding of waste (see *Zutrau v. Jansing*, 2014 WL 3772859, at *20 (Del. Ch. July 31, 2014)).

Exculpation from Liability

If a board of disinterested and independent directors has been found to have acted with gross negligence, it may be held to have breached its duty of care. However, Section 102(b)(7) of the DGCL provides that the certificate of incorporation of the corporation can contain a provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty. For an example of an exculpation provision, see Standard Document, Certificate of Incorporation (Short-Form DE): Paragraph 7.

The limitation of liability is only applicable to breaches of the duty of care. It is not available for breaches committed in bad faith or breaches resulting from a conflict of interest, both of which invoke the duty of loyalty.

A 102(b)(7) provision only eliminates the directors' monetary liability. It does not preclude the court from issuing an injunction to provide relief for the breach (*Malpiede v. Townson*, 780 A.2d 1075, 1095 (Del. 2001)).

A 102(b)(7) provision is not retroactive. It cannot exculpate the directors for any act or omission occurring before the effective date of the provision.

Exculpation under Section 102(b)(7) is only available for directors, not officers (*Gantler v. Stephens*, 965 A.2d 695 at n.37). For further discussion, see Practice Note, Fiduciary Duties of Officers of Corporations: No Statutory Exculpation.

A 102(b)(7) provision eliminates personal monetary liability, but does not erase the underlying breach of fiduciary duty. Consequently, a third party (such as a financial advisor) can be held liable for aiding and abetting a director's breach, even if the director who committed the breach is personally exculpated (*In re Rural Metro Corp. S'holders Litig.*, 88 A.3d 54, 86 (Del. Ch. 2014)), *aff'd*, *RBC Capital Markets, LLC v. Jervis*, 129 A.3d 816, 873 (Del. 2015)). For more on the elements for establishing a claim of aiding and abetting a breach of fiduciary duty, see Practice Note, Fiduciary Duties in M&A Transactions: Exculpated Breach Forms Basis for Financial Advisor Liability.

Indemnification and Advancement

In addition to the allowance for exculpation, Section 145 of the DGCL **requires** a corporation to indemnify a person who was made a party to a proceeding by reason of his service to the corporation and who has achieved success, on the merits or otherwise, in that proceeding. At the other end of the spectrum, the statute **prohibits** a corporation from indemnifying a corporate official who was not successful in the underlying proceeding and who acted in bad faith (such as if the officer knew that his actions were damaging to the company or that his conduct was unlawful).

By contrast with indemnification, advancement of a person's expenses as they are incurred (regardless of whether he will ultimately be entitled to indemnification) is permitted, but not required, by Section 145(e) of the DGCL. Directors and officers usually expect to receive full indemnification and advancement of expenses to the maximum extent allowed by law. For an example of an indemnification provision for a certificate of incorporation and discussion of advancement issues, see Standard Document, Certificate of Incorporation (Short-Form DE): Paragraph 8 and the associated Drafting Note.

Abstention Defense

Under Delaware law, a director who "plays no role in the process of deciding whether to approve a challenged transaction cannot be held liable on a claim that the board's decision to approve that transaction was wrongful" (*In re Tri–Star Pictures, Inc., Litig.*, 1995 WL 106520, at *2 (Del. Ch. Mar. 9, 1995)). But there are exceptions to this rule, such as if:

- Certain members of the board conspire with others to formulate a wrongful transaction, then deliberately absent themselves from the directors' meeting at which the proposal is to be voted upon, specifically to shield themselves from any exposure to liability.
- The director played a role in the negotiation, structuring, or approval of the proposal (*Valeant Pharm. Int'l v. Jerney*, 921 A.2d 732, 753 (Del. Ch. 2007)).
- An absent director knowingly accepts a personal benefit flowing from a self-interested transaction and refuses to return it upon demand. That director can be thought to have ratified the action taken by the board in his absence and, thus, share in the full liability of his fellow directors (*Valeant*, 921 A.2d at 753–54).
- The director abstained from the formal vote to approve the transaction, yet the director was closely involved with the challenged transaction from the beginning and the transaction was rendered unfair based, in large part, on the director's involvement (*Gesoff v. IIC Indus., Inc.*, 902 A.2d 1130, 1166 n.202 (Del. Ch. 2006)).

Breach Committed in Bad Faith

Exculpation under Section 102(b)(7) is unavailable for breaches of the duty of loyalty. In Delaware common law, the duty of good faith is analyzed as a component of the duty of loyalty, not as a standalone fiduciary duty (***Stone** ex rel. AmSouth Bancorporation v. **Ritter***, 911 A.2d 362, 370 (Del. 2006)). As a consequence, if the board's wrongful conduct is committed in bad faith, the directors at fault cannot rely on the charter's exculpation provision.

To act in good faith, a director must act with honesty of purpose and in the best interest of the corporation. No single definition or set of factors exists that defines good faith or bad faith, but the courts have identified several situations that usually involve bad faith. These include:

- An intentional failure to act in the face of a known duty to act, demonstrating a conscious disregard for one's duties. For example, a director knows management is violating corporate policy, but makes no attempt to change the situation.
- A knowing violation of law. For example, if a director approves a waste-removal plan knowing it violates environmental laws.
- If a director acts for any purpose other than advancing the best interests of the corporation or its stockholders. For example, if a director approves a sale transaction because the director wants to sell its stock.

(*In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 67 (Del. 2006).) Because a finding of gross negligence is necessary to establish a breach of the duty of care (which is exculpated by a Section 102(b)(7) provision), a bad-faith act (which is not exculpated) must be "qualitatively more culpable than gross negligence" (*Disney*, 906 A.2d at 66). An element of **scienter**, or actual or constructive knowledge of the improper action, is necessary.

For an example of a conscious disregard of duties, the board is not entitled to the presumptions of the business judgment rule if the plaintiff demonstrates with particularized allegations that the board knowingly or deliberately failed to adhere to the terms of a stock incentive plan (*Pfeiffer* ***v***. *Leedle*, 2013 WL 5988416, at *5 (Del. Ch. Nov. 8, 2013)). A knowing or intentional violation is inferred if the board violates an unambiguous term in such a plan (*Sanders* ***v***. *Wang*, 1999 WL 1044880, at *7-9 (Del. Ch. Nov. 10, 1999)) or award (*Pfeiffer*, 2013 WL 5988416, at *7-8).

By contrast, a board's failure to have a CEO succession plan in place is not considered a conscious disregard of a known duty to act in the absence of a recognized duty to implement such a plan (which there is not; see *Zucker* ***v***. *Andreessen*, 2012 WL 2366448, at *11 (Del. Ch. June 21, 2012)).

Failure of Oversight

Assuming a situation in which the business judgment rule applies (meaning that there is no conflict of interest and no other set of facts that calls for a heightened standard of review) and assuming the directors are exculpated by a 102(b)(7) provision, a claim of breach of fiduciary duty must be premised on establishing bad faith on the part of the board. This claim frequently takes the form of what practitioners and courts call a "*Caremark* claim." In these claims, the plaintiff argues that the board did so little to oversee the corporation's operations and exposure to risk that its failures amount to a conscious disregard of its duty to stay informed. As discussed in Breach Committed in Bad Faith, conscious disregard of a known duty to act is a recognized element for establishing bad faith.

To satisfy its duty to stay informed and oversee the company's exposure to risk, the board must take efforts to implement an information and reporting system. From the perspective of corporate law, this duty is relatively easily discharged; only an utter failure to attempt to implement a plan will establish the lack of good faith that is a necessary condition for liability. If the board implements a reporting system, the plaintiff will not prevail on an argument that the system could have been stronger.

The Delaware courts established the parameters of the duty of oversight in the *Caremark* and ***Stone*** ***v***. ***Ritter*** decisions. In *Caremark*, the plaintiffs alleged the directors breached their duty of oversight when certain employees violated the federal law prohibiting payment to induce Medicare or Medicaid referrals. In ***Stone*** ***v***. ***Ritter***, the plaintiffs alleged the directors breached their duty of oversight because the corporation failed to comply with the Bank Secrecy Act. In both of those cases, the court held that directors need to assure themselves in good faith that the corporation has reporting systems in place that are reasonably designed to provide timely and accurate information to the board. As a result, directors expose themselves to liability if either:

- They utterly failed to implement any reporting or information system or controls (*In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996)).
- 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. Assuming that the corporation's charter has a 102(b)(7) provision (so that a breach of the duty of care is insufficient grounds for liability), this basis for liability requires the plaintiff to plead 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)). This essentially requires a showing of scienter, that the directors knowingly acted for reasons other than the best interests of the corporation.

In the *Caremark* and ***Stone*** ***v***. ***Ritter*** decisions, the court held the respective boards breached their fiduciary duties because they knowingly failed to discharge their duties and acted in bad faith. In general, however, *Caremark* claims are considered "possibly the most difficult theory in corporation law on which a plaintiff might hope to win a judgment" (*In re General Motors Co. Deriv. Litig.*, 2015 WL 3958724, at *14 (Del. Ch. June 26, 2015)). To illustrate, in a decision regarding the GM board's conduct when it learned of the company's ignition-switch failures, the court held that the plaintiffs had failed to plead sufficient facts to demonstrate bad faith, because the board had not failed to establish **any** oversight plan. The board's negligent controls and apathetic culture were still not enough to establish bad faith.

Other examples from the case law of *Caremark* claims that failed because the plaintiff did not demonstrate that the board consciously disregarded its duty to oversee the company's compliance with applicable laws include:

- *Melbourne Mun. Firefighters' Pension Trust Fund* ***v***. *Jacobs*, 2016 WL 4076369 (Del. Ch. Aug. 1, 2016), *aff'd*, 158 A.3d 449 (Del. 2017). The directors of Qualcomm Inc. were alleged to have allowed the company to repeatedly violate international antitrust laws after being aware of previous violations. The court held that the plaintiff did not adequately plead facts showing that the board's response to the "red flags" in question constituted bad faith.
- *Reiter* ***v***. *Fairbank*, 2016 WL 6081823 (Del. Ch. Oct. 18, 2016). The directors of Capital One Financial Corporation were alleged to have failed to monitor the bank's check-cashing business for the risk of money laundering. The court dismissed the claim for the reason that the plaintiff did not identify a key event or particular document that would constitute a red flag that the board overlooked. The court described the plaintiff's complaint as pleading "at most flags of a different hue, namely yellow flags of caution…" (2016 WL 6081823, at *13).
- *Horman* ***v***. *Abney*, 2017 WL 242571 (Del. Ch. Jan. 19, 2017). The directors of United Parcel Service, Inc. were alleged to have failed to oversee the company's compliance with cigarette-transportation laws. The court held that the plaintiff had failed to demonstrate that the board had overlooked any red flags, noting that it is insufficient to allege that the board must have received the pertinent information since the officer charged with passing that information to the board had received the information. Instead, the plaintiff must plead with particularity that the officer actually reported the information to the board. The court also noted that when the board was eventually made aware of the red flags, it was also informed of efforts underway to ensure compliance with the relevant laws.
- *In re Qualcomm Inc. FCPA S'holder Derivative Litig.*, 2017 WL 2608723 (Del. Ch. Jun. 16, 2017). The derivative complaint alleged that the board of Qualcomm ignored red flags concerning the company's compliance with the Foreign Corrupt Practices Act. The SEC had concluded that the company had violated the FCPA by providing gifts and other entertainment to Chinese officials, along with other violations. The company settled with the SEC and paid a fine, which prompted the stockholder complaint. Here the court did not rule on the redness of the flags in question, but

held that the board had not ignored its duties when made aware of the potential violations. Documents showing that the company planned to take remedial actions meant that the board had not ignored any red flags.

- *Okla. Firefighters Pension & Ret. Sys. v. Corbat*, 2017 WL 6452240 (Del. Ch. Dec. 18, 2017, *reargument denied*, 2018 WL 1254958 (Del. Ch. Mar. 12, 2018). The directors of Citigroup, Inc. were alleged to have failed to enforce internal controls to prevent violations of money-laundering and other rules. The court noted that because the issue concerns the duty of loyalty, "a board's efforts can be ineffective, its actions obtuse, its results harmful to the corporate weal, without implicating bad faith" (2017 WL 6452240, at *17).

Apart from the analysis of the board's fiduciary duties, directors have compelling reasons to closely monitor the company's business and risks. A corporation can be held responsible for the actions of its management and employees. Since the board of directors is charged with overseeing those managers and employees on behalf of the corporation, the board needs a functioning oversight and compliance system in place. The Federal Sentencing Guidelines impose large penalties on corporations for violation of federal criminal laws, but these penalties can be significantly reduced if corporations put appropriate oversight and compliance programs in place. For a public corporation, the board must consider the additional compliance requirements of the SEC and the exchange on which its stock is listed. Federal regimes of corporate governance have their own standards of review that may be stricter on directors than Delaware corporate law; these regimes require their own compliance procedures. However, strictly as a matter of corporate law and liability to stockholders, claims by plaintiff stockholders that the board utterly failed to oversee the company's risks tend to be hard to litigate successfully.

Directors of Foreign-Based Corporations

One situation in which the Delaware Court of Chancery has more readily found a basis for a *Caremark* claim is when directors of foreign-based Delaware corporations fail to oversee the corporation's activities, particularly when they do little more than hold a handful of telephonic meetings. In *Puda Coal*, the court refused to dismiss a claim against the independent directors of a China-based corporation, holding that it was "perfectly conceivable" that the directors had failed to make a good-faith effort to monitor the company's management. The court advised that to meet the bare minimum for avoiding personal liability under *Caremark*, a director must:

- Be frequently present in the country the corporation is based.
- Have in place a system of adequate controls and retain accountants and lawyers who are equipped to maintain those controls.
- Possess "the language skills to navigate the environment in which the company is operating."

(*In re Puda Coal, Inc. S'holders Litig.*, C.A. No. 6476-CS, 2013 WL 769400 (Del. Ch. Feb. 6, 2013) (TRANSCRIPT).)

The court further developed this guidance in *Rich ex rel. Fuqi International, Inc. v. Chong*, 66 A.3d 963 (Del. Ch. 2013). There the court held that although the corporation nominally had controls in place, its own disclosures of its material weaknesses showed that it had no "**meaningful**" controls, and that although the board had regular meetings, it had no system at all for regulation of the company's operations "**in China**" (emphasis in original). The court also highlighted the board's repeated failure to identify and respond to "red flags" that should have warned of the company's material weaknesses in its controls, which rose to the level of a conscious failure to monitor. The court added that a director cannot avoid liability by resigning, and found it "troubling" that independent directors would abandon a faltering company to the sole control of those who had harmed it. A third decision on absentee directors of China-based corporations reiterated these themes (see *In re China Agritech S'holder Deriv. Litig.*, 2013 WL 2181514 (Del. Ch. May 21, 2013)).

Nonresident Directors

The flip side of the situation in which courts review the conduct of directors of Delaware corporations based overseas is the situation in which Delaware courts are asked to review the conduct of nonresident directors. Foreign-based directors cannot evade Delaware courts just because they are not resident in Delaware, or even in the United States. Under Section 3104 of Title 10 of the Delaware Code, Delaware's **long-arm statute**, non-resident directors and officers of Delaware corporations implicitly accept **personal jurisdiction** in Delaware courts in two types of cases:

- For any civil action or proceeding brought in Delaware, by or on behalf of, or against the corporation, in which the individual is a necessary or proper party.
- For any action or proceeding against the individual for violation of a duty in their capacity as a director or officer.

The court has jurisdiction over the director or officer even if the plaintiff does not allege a breach of fiduciary duties, as long as the traditional minimum-contacts test is met (*Hazout v. Tsang Mun Ting*, 2016 WL 748490 (Del. Feb. 26, 2016)).

Conflict Transactions and Entire Fairness

The "entire fairness" standard of review, Delaware law's "most onerous standard" (*In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 44 (Del. Ch. 2013)), applies in two general circumstances:

- If at least half of the directors who approved the transaction were not disinterested and independent (*Aronson v. Lewis*, 473 A.2d at 812). See Finding a Conflict of Interest for further discussion.
- When a controlling shareholder stands on both sides of the transaction (*In re KKR Fin. Hldgs. LLC S'holder Litig.*, 101 A.3d 980, 990 (Del. Ch. Oct. 14, 2014), citing *Williamson v. Cox Commc'ns Inc.*, 2006 WL 1586375, at *4 (Del. Ch. June 5, 2006)). See Controlling-Stockholder Transactions for further discussion.

When entire fairness attaches to the act in question, the defendant directors must establish both:

- **Fair dealing.** How the transaction was timed, initiated, structured, negotiated, disclosed by management to the directors, approved by the board and shareholders.
- **Fair price.** All relevant factors: assets, market value, earnings, future prospects, any other elements that affect the intrinsic value of the stock.

(*Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983).)

The distinction between price and process is "not always neatly distinguishable" (*Hamilton Partners, L.P. v. Highland Capital Mgmt., L.P.*, 2016 WL 612233, at *5 (Del. Ch. Feb. 2, 2016)). The inquiry is not bifurcated. The court conducting an entire fairness review examines the transaction for both procedural and substantive fairness and reaches a "unitary conclusion" (*In re Nine Sys. Corp. S'holders Litig.*, 2014 WL 4383127, at *47 (Del. Ch. Sept. 4, 2014)). Usually, a fair process results in a fair price, and evidence of fair dealing can help convince the court that the board obtained a fair price (Americas Mining Corp. v. Theriault, 51 A.3d 1213, 1244 (Del. 2012)). But this is not always the case.

For example, in the *Trados* decision, the Chancery Court concluded that a merger satisfied entire fairness in spite of an unfair process that led to it. The court held that the directors were personally interested in the transaction and that the board had wrongfully considered only the interests of the preferred stock, to the exclusion of the interests of the common stockholders. However, the court deemed the deal fair based on price, because the value of the common stock in the company as a going concern would have been worthless (*In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 78 (Del. Ch. 2013)).

By contrast, in *Nine Systems*, the Chancery Court held that a recapitalization transaction whose price was fair to the common stockholders still failed entire

fairness review because of an unfair process (*Nine Sys. Corp.*, 2014 WL 4383127, at *46). To rationalize the apparent conflict with *Trados*, the court distinguished recapitalizations, in which the company's shareholders remain on as shareholders in the company, from third-party mergers, where price might be the more critical element.

Liability for Failing to Satisfy Entire-Fairness Review

If a majority of the directors hold a personal interest in a transaction, or if a majority of the directors are not independent, they lose the presumption that they acted in the best interest of the corporation.

Directors are not deemed to have breached their fiduciary duties just because they were not disinterested and independent. As discussed at length, directors have a defense against liability for breach of the duty of care if the corporation's charter contains an exculpation clause under Section 102(b)(7) of the DGCL. Alternatively, the directors may be able to claim that in spite of a failure to satisfy the price prong of entire-fairness review, the directors themselves justifiably relied on their advisors, as authorized by Section 141(e) of the DGCL.

Breaches of the duty of loyalty, however, cannot be exculpated. If a self-dealing transaction has been found unfair and the corporation has an exculpatory provision, the directors can be found liable in one of two ways:

- Any directors disinterested and independent of the controlling stockholder can be held liable, but only if they are found to have approved the transaction in bad faith. This finding requires an inquiry into each director's state of mind. Furthermore, the disinterested and independent directors can win dismissal of the complaints against them at the pleadings stage without having to remain as a defendant until the ultimate conclusion of the litigation (*In re Cornerstone Therapeutics Inc. S'holder Litig.*, 115 A.3d 1173, 1180 (Del. 2015)).
- Any director lacking in disinterest or independence is subject to damages regardless of the individual's subjective bad faith (*Cornerstone Therapeutics*, 115 A.3d at 1181).

Finding a Conflict of Interest

Disinterest and independence are determined on a director-by-director basis (*Trados*, 73 A.3d at 45). If a majority of the directors are disinterested and independent, they cleanse the rest of the board and the board remains entitled to the presumptions of the business judgment rule. If half or more of the directors are not disinterested and independent, the decisions of the board are reviewed for their entire fairness.

Director Disinterest

Under Delaware law, the test for a finding of a disabling 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 (*Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993)).
- 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)).

The materiality of a financial benefit to a director is determined in the context of the director's personal financial circumstances. The benefit has to have made it improbable that the director could perform their fiduciary duties without being influenced by their overriding personal interest (*New Jersey Carpenters Pension Fund v. infoGROUP, Inc.*, 2011 WL 4825888, at *9 (Del. Ch. Sept. 30, 2011)). The benefit must cause the director's personal interest to diverge from the shareholders' interests at large. The fact that a director owns shares in the company and would stand to gain from a sale does not itself represent a disabling interest. On the contrary, the courts frequently see that factor as aligning the director's interests with the rest of the shareholders'. It would take a "compelling" or "idiosyncratic" need for liquidity for a director's equity stake to be interpreted as a cause for conflict of interest

(*In re Crimson Exploration Inc. S'holder Litig.*, WL 5449419, at *19-20 (Del. Ch. Oct. 24, 2014)).

Directors are considered to be conflicted when the board decision concerns the director's own compensation (*Cambridge Ret. Sys.*, 2014 WL 2930869, at *3).

Director Independence

Under Delaware law, there is a presumption of director independence that must be rebutted. A director is presumed to be independent even when appointed by a controlling shareholder or other allegedly interested party (*Aronson v. Lewis*, 473 A.2d at 816).

To successfully challenge a director's independence, plaintiffs must show that the director is so "beholden" to the controller or so under its 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 controller 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 also not enough (*In re The Limited, Inc.*, 2002 WL 537692, at *5 (Del. Ch. Mar. 27, 2002)). 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 often a fact-specific inquiry. For example, in various contexts, the Delaware Court of Chancery has held that:

- A director was independent and not forced to approve a challenged transaction by the 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 a reasonable doubt regarding the director's independence (*Goldman v. Pogo.com, Inc.*, 2002 WL 1358760, at *3 (Del. Ch. Jun. 14, 2002)).
- 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, and were otherwise retired (*Friedman v. Dolan*, 2015 WL 4040806 (Del. Ch. Jun. 30, 2015)).

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, for purposes of demand futility, that a director deriving primary employment and income from the company and having a close friendship of more than 50 years with the company's chairman and largest stockholder was not independent for demand-futility purposes. In a similar vein, the Delaware Supreme Court ruled that a network of business relationships and venture capital investments between two directors and the company's controlling stockholder raised a reasonable doubt as to those directors' impartiality (*Sandys v. Pincus ("Zynga")*, 2016 WL 7094027 (Del. Dec. 5, 2016)). The *Sanchez* and *Zynga* decisions may signal a greater willingness on the part of the Supreme Court to question a director's independence, though ultimately any case can only be determined on its own specific facts. For further discussion of decisions from the Delaware judiciary on director independence, see Practice Note, Shareholder Derivative Litigation: When Demand Requirement Is Excused.

Ratification for a Conflict of Interest

Although entire fairness presumptively applies to review of transactions in which half the directors are not disinterested and independent, the business judgment

rule can be restored if the stockholders ratify the action taken by the board.

Section 228 of the DGCL permits action by written consent of a majority of the shares without a meeting, prior notice, or a vote. However, notice of the written consent must be promptly given to the non-assenting shareholders. The requirements of Section 228 must be strictly adhered to for the ratification to be effective (see *Espinoza v. Zuckerberg*, 124 A.3d 47 (Del. Ch. 2015)).

Directors are considered to be interested in their own compensation (with no materiality standard). The Delaware Supreme Court has recognized three scenarios that involve the ratification defense in connection with stockholder-approved equity incentive plans and awards made under those plans:

- When the stockholders approve the specific director awards.
- When the plan is "self-executing," meaning that the directors have no discretion when making the awards.
- When the directors exercise discretion and determine the amount and terms of the awards after stockholder approval.

(*In re Investors Bancorp S'holder Litig.*, 177 A.3d 1208, 1222 (Del. 2017).) The first two scenarios, in the court's words, "present no real problems." But in the third scenario, the ratification defense cannot be used to extinguish the entire fairness standard of review when a breach of fiduciary duty has been properly alleged, despite the incentive plan's limits. The board must still exercise its authority equitably, consistent with its fiduciary duties.

Note that if the corporation has a controlling stockholder, then in a transaction in which the controller stands on both sides, the approval of a majority of the minority shareholders will not, on its own, restore the presumptions of the business judgment rule. It will, however, shift the burden of proof to the plaintiff to prove that the transaction was unfair.

Similarly, the board can form a committee of disinterested and independent directors to make decisions that would constitute a conflict for the other members of the board. Doing so does not itself restore the presumptions of the business judgment rule, but it too shifts the burden of proof to the plaintiff to prove that the transaction was unfair.

Controlling-Stockholder Transactions

A transaction does not trigger entire-fairness review just because the company has a controlling stockholder (*Crimson Exploration*, 2014 WL 5449419, at *12). If the company enters into a third-party transaction and the controlling stockholder shares its control premium equally with the minority stockholders, the appearance of conflict is avoided at the outset (see *In re Synthes, Inc. S'holder Litig.*, 50 A.3d 1022, 1039 (Del. Ch. 2012) and *In re Morton's Rest. Grp. Inc. S'holders Litig.*, 74 A.3d 656, 662 (Del. Ch. 2013)). In that event, the business judgment rule applies.

Even in a transaction in which the controlling stockholder's interests conflicted with the minority stockholders', the plaintiff must allege that the controller used her power in an unfair manner (*In re Molycorp., Inc. S'holder Deriv. Litig.*, 2015 WL 3454925, at *7 (Del. Ch. May 27, 2015)). A transaction between a controlling stockholder and the company is not *per se* invalid under Delaware law. A controller transaction is perfectly acceptable if it satisfies entire fairness (*Monroe Cnty. Empls.' Ret. Sys. v. Carlson*, 2010 WL 2376890, at *2 (Del. Ch. June 7, 2010)).

The Delaware Court of Chancery has ruled explicitly that the entire-fairness framework does not apply only to squeeze-out mergers (the context in which it arises most frequently), but to any transaction in which the controller extracts a non-ratable benefit (*In re EZCORP Inc. Consulting Agreement Derivative Litig.*, 2016 WL 301245, at *11-12 (Del. Ch. Jan. 25, 2016)).

Defining Control for Entire Fairness

The threshold issue in controller transactions regarding the court's review of the board's conduct is whether the controller was in fact a controlling stockholder.

Delaware law defines "controlling stockholder" as a stockholder who either:

- Owns more than 50% of the voting power of the corporation.
- Exercises control over the business and affairs of the corporation.

(*Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1113-14 (Del. 1994).)

Based on the control test, a stockholder can be a "controlling stockholder"—and thereby itself owe fiduciary duties to the other stockholders as well as trigger entire-fairness review if its interests diverge from the minority stockholders'—even if it owns only a minority of the company's shares. However, a stockholder is not considered a controlling stockholder unless it has "such formidable voting and managerial power" that, as a practical matter, it is no differently situated than if it had majority voting control (*In re PNB Hldg. Co. S'holders Litig.*, 2006 WL 2403999 (Del Ch. 2006)).

The question of whether a stockholder should be deemed controlling can only be answered on the facts of the particular case. For example:

- A 27.7% stockholder with two representatives on a board with ten members was not considered a controlling stockholder (*Morton's Rest. Grp.*, 74 A.3d at 661).
- A 49.7% stockholder with two representatives on a board with nine members was not considered a controlling stockholder (*Ivanhoe P'rs v. Newmont Mining Corp.*, 535 A.2d 1334, 1344 (Del. 1987)).
- A 43.3% stockholder with five representatives on a board with 11 members was considered a controlling stockholder (*Kahn v. Lynch*, 638 A.2d at 1114).

Other indicators of influence aside from board-designation rights can also be relevant to determining whether a stockholder is controlling. For example, the Chancery Court has held that a stockholder's separate contractual rights, when combined with significant stock holdings, can support a finding that a particular stockholder is controlling (*Superior Vision Servs. Inc. v. ReliaStar Life Ins. Co.*, 2006 WL 2521426, at *5 (Del. Ch. Aug. 25, 2006)). On that basis, the court has held that:

- A 39% stockholder who was also the CEO and chairman of the board was reasonably considered to be the controlling stockholder because he "used his influence on the corporation...to his own benefit and to the detriment of the interests of the minority stockholders" (*La. Mun. Police Employees' Ret. Sys. v. Fertitta*, 2009 WL 2263406, at *7 (Del. Ch. July 28, 2009)).
- A stockholder was deemed controlling because it held 48% of a corporation's stock, 82% of its debt, and it entered into short-term forbearance agreements with the corporation to time the corporation's restructuring (*Hamilton P'rs L.P. v. Highland Capital Mgmt., L.P.*, 2014 WL 1813294 (Del. Ch. May 7, 2014)).
- A 26% stockholder with significant veto rights over the company's ability to raise new debt financing or file for a voluntary bankruptcy was a controller (*Calesa Assoc., L.P. v. Am. Capital, Ltd.*, 2016 WL 770251, at *10 (Del. Ch. Feb. 29, 2016)). (Notably, the *Calesa* court distinguished *Superior Vision Services* and discounted the stockholder's contractual rights in its analysis, even though those rights gave the stockholder effective control over the company's decision-making. The decisions can potentially be reconciled in light of the fact that the Calesa stockholder's 26% stake may not be significant enough even under *Superior Vision Services*.)
- It was reasonably conceivable that Elon Musk, as CEO, Chairman, and 22.1% stockholder, who was the company's "visionary" and whose own "outsized influence" over Tesla and its stockholders had been acknowledged in the company's SEC filings, was the controlling stockholder of Tesla (*In re Tesla Motors, Inc. S'holder Litig.*, 2018 WL 1560293, at *13-19 (Del. Ch. Mar. 28, 2018)).
- There was reasonable doubt that the board of Oracle could exercise business judgment in

deciding whether to bring a derivative claim against Larry Ellison, given that Ellison was the company's founder, Chairman, long-time former CEO, Chief Technology Officer, 28% stockholder, and dominant figure who also exerted "outsized influence" at the company and who had removed directors in the past who had displeased him (*In re Oracle Corp. Deriv. Litig.*, 2018 WL 1381331, at *15-20 (Del. Ch. Mar. 19, 2018)).

In *Crimson Exploration*, the Chancery Court surveyed several previous decisions that had addressed the definition of control and concluded that there is no "linear, sliding-scale approach whereby a larger share percentage makes it substantially more likely that the court will find the stockholder was a controlling stockholder" (2014 WL 5449419, at *10). Rather, the test for control is whether the stockholder exercised actual control over the board (not just management) during the board's evaluation of the challenged transaction itself (see *In re Sanchez Energy Deriv. Litig.*, 2014 WL 6673895, at *8 (Del. Ch. Nov. 25, 2014), *overturned on other grounds*, *Del. Cnty. Emps. Ret. Fund v. Sanchez*, 124 A.3d 1017 (Del. 2015); *In re KKR Fin. Hldgs. LLC S'holder Litig.*, 101 A.3d 980, 995 (Del. Ch. 2014)). Under this test, minority stockholders will ordinary not be considered controllers, but certain factors will weigh in favor of a finding of control, including:

- Outsized influence by the stockholder.
- Past actions indicating exertion of control.
- Acknowledgments by the company in its SEC filings of the stockholder's influence.
- Whether the board took steps to neutralize the stockholder's control.

Even if no individual stockholder owns enough shares or exerts enough control to qualify as a controlling stockholder, two or more stockholders, working in tandem, may collectively be considered a control group for purposes of the standard of review for controlling-stockholder transactions. To constitute a control group, allegations of mere "parallel interests" between the stockholders, without more, are insufficient (*Williamson v. Cox Commc'ns, Inc.*, 2006 WL 1586375, at *6 (Del. Ch. June 5, 2006)). The stockholders must instead be connected by contract, common ownership, agreement, or other arrangement and be working together toward a shared goal to be deemed a control group (*PNB Hldg. Co.*, 2006 WL 2403999, at *9-10). This is a fact-intensive inquiry that can turn on factors such as a long history of cooperation and coordination between the group members in their investments and concurrent entry into the principal documents for the transaction in question (see *In re Hansen Medical, Inc. S'holders Litig.*, 2018 WL 3030808, at *7 (Del. Ch. Jun. 18, 2018)).

No Exculpation for Controllers

Exculpatory provisions do not benefit the controlling stockholders themselves in their role as controllers (*In re Dole Food Co., Inc. S'holder Litig.*, 2015 WL 5052214, at *39 (Del. Ch. Aug. 27, 2015), citing *In re Emerging Commc'ns S'holder Litig.*, 2004 WL 1305745, at *38 (Del. Ch. May 3, 2004)). A controller engaging directly or indirectly in an interested transaction is potentially liable for breach of fiduciary duty even if it participated in the transaction through intervening entities. The plaintiff does not have to make a case that the controller aided and abetted breaches committed by the directors (*EZCORP*, 2016 WL 301245, at *9).

Avoiding Entire Fairness Review with Procedural Protections

In virtually all cases where entire fairness presumptively applies, the parties can structure the transaction to either shift the burden of proof of the transaction's fairness back to the plaintiff or even qualify for the presumptions of the business judgment rule. These structures are used most frequently in the context of M&A transactions between a corporation and its controlling stockholder and are discussed in depth in Practice Note, Fiduciary Duties in M&A Transactions: Transaction Structures that Trigger Entire Fairness.

If a corporation does not have a controlling stockholder, yet the board lacks an independent and disinterested majority, the board can still qualify for business

judgment review by empowering a committee of independent and disinterested directors to make the relevant decision (8 Del. C. § 141(c); *Frederick Hsu Living Trust v. ODN Hldg. Corp.*, 2017 WL 1437308 (Del. Ch. Apr. 14, 2017)). If the board delegates its full power to address an issue to a committee, then the judicial analysis focuses on the committee. A decision made by a disinterested, independent, and informed majority of the committee receives business judgment deference (*Trados*, 73 A.3d at 65 n.39).

Ratification of Non-Transformative Decisions

The procedural protections that allow the directors to obtain the presumptions of the business judgment rule are necessary in the context of a buyout by the controlling stockholder. However, the Delaware Court of Chancery has held that decisions that are not "transformative," such as decisions over annual compensation, are entitled to more deference than entire fairness, even without the full set of protections (*In re Tyson Foods, Inc. Consol. S'holder Litig.*, 919 A.2d 563, 589 (Del. Ch. 2007); *Friedman v. Dolan*, 2015 WL 4040806, at *6 (Del. Ch. Jun. 30, 2015)).

The *Dolan* court explained that procedural protections are necessary when there are concerns of informational advantage on the part of the stockholder and that the controller will exercise leverage over the other stockholders. When these concerns are absent, the court applies the business judgment rule, even to a decision involving the controlling stockholder, as long as the decision was taken by a body comprised of a majority of independent directors. If the full board approved the transaction, then a majority of the board must have been disinterested and independent. If less than a majority of all the directors are disinterested and independent, the business judgment rule can still be salvaged if a committee made up of a majority of independent directors made the decision in question.

Intermediate Standard of Review: Enhanced Scrutiny

Certain situations, owing to the possibility of a conflict of interest, trigger heightened scrutiny of the board's conduct when determining if the directors carried out their fiduciary duties. This means the business judgment rule is not available until certain hurdles are met, because the directors' action or inaction could potentially have a more damaging effect on the stockholders.

Defensive Measures Against Takeovers

In a successful contested takeover, management and the board of directors are frequently replaced by the hostile actor. Because of the possibility that the directors will act to save their seats on the board rather than in the best interests of the corporation, Delaware courts apply a heightened test when examining anti-takeover defensive measures (see *Unocal v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985)). When implementing defensive measures, the directors must show:

- Reasonable grounds for believing a danger existed to the operation or policies of the corporation. Because the *Unocal* analysis is very fact-intensive, the board of directors should ensure that there is a reasonable and good faith investigation by non-management directors (if possible) before any defensive measures are put in place.
- The defensive measure was reasonable in relation to the threat. Defenses that preclude all offers for the corporation or coerce stockholders to approve a management-sponsored bid are generally considered unreasonable in relation to a threat.

If the directors fail to prove the two elements above, they must show that the actions they took were entirely fair to the corporation.

For further discussion of defensive measures in the context of hostile takeovers, see Practice Notes, Defending Against Hostile Takeovers and Poison Pills: Defending Against Takeovers/Stockholder Activism and Protecting NOLs.

Interference with Stockholder Vote

Stockholders can influence the management of the corporation by:

- Electing (or withholding votes for) directors.
- Voting with their feet by selling their shares of stock.

The right to elect directors is especially important because it allows stockholders to influence the management of the corporation without selling their shares. If the board acts with the primary purpose of interfering with the fundamental right to elect directors, the board must show it had compelling justification for doing so (see *Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988)*). If the board can show it had a compelling justification, then the business judgment rule applies. Meeting this standard is difficult, so courts typically only apply it when the board truly acts with the primary purpose of disenfranchising the stockholders.

In 2007, the Delaware Court of Chancery found that a board had a compelling justification when it postponed a stockholder vote in order to get more votes for a merger that was going to be voted down (see *Mercier v. Inter-Tel, Inc.*, 929 A.2d 786 (Del. Ch. 2007)). In *Inter-Tel*, the court applied a modified *Unocal* standard. Under this revised standard, the directors had to show that:

- They pursued a legitimate corporate objective motivated by a good faith concern for the stockholders' best interests and did not preclude the stockholders from their right to vote or coerce them to vote in a particular way.
- Their actions were reasonable in relation to the threat.

Although the court applied this revised standard, it also found that the directors had a compelling justification for their actions. Significantly, several important facts in this case helped to justify the board's actions including that:

- The stockholders were about to reject a merger proposal.
- A special committee of independent directors believed the merger to be in the best interest of the stockholders.
- New information relevant to the merger had not yet been disclosed (such as the second quarter financial results).
- The directors reasonably feared losing the offer if stockholders voted against the merger.
- The directors rescheduled the meeting within a reasonable time period.

Sale of Control

In the context of a change of control or the break-up of a corporation, the Delaware courts also apply the heightened reasonableness standard introduced in *Unocal* when reviewing the conduct of directors (see *Revlon, Inc. v. MacAndrews & Forbes Hldgs., Inc.*, 506 A.2d 173 (Del. 1986)). In this context, the Delaware courts place the burden on the board of directors to obtain the highest value reasonably available to the stockholders (a standard of review known as "*Revlon* duties"). *Revlon* duties attach only once the directors have decided to sell the company, or before that, if a sale has become inevitable. The board is not subject to *Revlon* duties merely because the corporation is "in play" or a candidate for takeover (see *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235, 242 (Del. 2009)). If the directors fail to meet their *Revlon* duties, they must show that the sale transaction was entirely fair to the corporation. Usually, the highest value is interpreted to mean the highest purchase price, but the board of directors can consider other factors such as certainty of completion in light of required financing and governmental consents.

For detailed discussion of *Revlon* scrutiny in change-of-control transactions, including the types of transactions

that trigger *Revlon*, satisfying enhanced scrutiny, liability for failure to satisfy *Revlon*, and restoring the presumptions of the business judgment rule under the *Corwin* decision, see Practice Note, Fiduciary Duties in M&A Transactions: Sale of Control.

No Enhanced Scrutiny for Dissolutions

The Delaware Court of Chancery has held that a board's decision to adopt and implement a plan of **dissolution** does not trigger enhanced scrutiny under *Revlon* or *Unocal* (*The Huff Energy Fund, L.P. v. Gershen*, 2016 WL 5462958 (Del. Ch. Sept. 29, 2016)). The court explained that *Revlon* applies only to "final stage" transactions like a sale or break-up of the company. Dissolutions, by contrast, require a three-year wind-up period during which the directors maintain their duty to act in the best interests of the corporation (see Practice Note, Dissolving a Delaware Corporation: Continuation of Corporation after Dissolution).

The court also rejected the argument that the dissolution constituted an unreasonable poison pill under *Unocal* by virtue of the fact that it would prevent the plaintiff stockholder from buying any more shares of the company. Given that following dissolution, the company must wind up its affairs, there cannot be said to be a specter of entrenchment on the part of the directors.

Subsidiary Duties

The duty of care and the duty of loyalty represent the two main fiduciary duties of the board of directors, but certain components of those duties are sometimes singled out and discussed as stand-alone duties.

Duty of Good Faith

Good faith is not a separate fiduciary duty, but is a component of the duty of care and the duty of loyalty, as follows:

- **Duty of care.** A director must use good faith when exercising the duty of care. If a plaintiff can prove that the director acted in bad faith, then the presumptions of the business judgment rule will not protect the director from liability. Similarly, directors cannot seek limitation of liability under Section 102(b)(7) of the DGCL for actions taken in bad faith (see Duty of Care). Consequently, if a corporation's charter exculpates the directors under Section 102(b)(7) for breaches of the duty of care, a plaintiff must demonstrate bad faith on the directors' part to succeed on a fiduciary duty claim.
- **Duty of loyalty.** A director acting in bad faith does not act in the best interest of the corporation. In the ***Stone v. Ritter*** litigation, the Delaware court said the failure to act in good faith does not automatically result in a breach of duty, but becomes a factor when determining a breach of the duty of loyalty (see ***Stone*** *ex rel. AmSouth Bancorporation* ***v. Ritter***, 911 A.2d 362 (Del. 2006)).

Duty to Obey the Law

Directors have a duty to comply with the law. If a director knowingly breaks the law, the director is denied the protection of the business judgment rule and cannot benefit from limited liability under Section 102(b)(7) of the DGCL (see Duty of Care). A knowing violation of law is evidence of bad faith. Breaking the law for the interest of the corporation is not an excuse. For example, directors breach their fiduciary duties when they pay bribes to foreign officials even if it results in a large profit for the corporation.

Duty of Disclosure

Directors also hold a fiduciary duty to communicate honestly with the stockholders and to make full and fair disclosures. This duty, also referred to as a "duty of candor," does not obligate the board to provide all of the corporation's financial or business information to the stockholders. Rather, the information must meet a materiality standard of a "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable stockholder as having

significantly altered the total mix of information made available" (*Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 944 (Del. 1985)). Delaware law does not require the board of directors to disclose information simply because that information "might be helpful" (*Skeen v. Jo-Ann Stores, Inc.*, 750 A.2d 1170, 1174 (Del. 2000)). The courts have similarly admonished against "the fallacy that increasingly detailed disclosure is always material and beneficial disclosure" (*Zirn v. VLI Corp.*, 1995 WL 362616, at *4 (Del. Ch. June 12, 1995)). The board is also entitled to keep certain information confidential in order for the corporation to succeed (*Stroud v. Grace*, 606 A.2d 75, 89 (Del. 1992)).

The Delaware Court of Chancery has identified four recurring scenarios where the duty of disclosure may arise:

- When the board of directors seeks a statutorily required stockholder approval for an action, directors hold a fiduciary duty to disclose fully and fairly all material information that the board controls. For example, a **proxy statement** for the approval of a merger would be misleading if it failed to disclose a CEO's personal financial interest in the merger (see *In re Lear Corp. S'holder Litig.*, 926 A.2d 94 (Del. Ch. 2007)).
- When the board of directors seeks a stockholder ratification that is not required by the DGCL of a transaction in which a director or officer has a personal interest that conflicts with the corporation's interest, directors must disclose all material facts that the board controls.
- When a director communicates publicly or directly with stockholders, with or without a request for stockholder action, the director must not speak falsely so as to misinform the stockholders. In other words, if a director discloses information, it must be truthful.
- When a director either directly buys or sells shares from or to an outside stockholder in a private stock sale, the director must disclose any material information that qualifies as special facts or circumstances, including knowledge of important transactions, prospective mergers and probable sales of entire assets or business. The duty to disclose in this scenario only arises if the director also deliberately misleads the stockholder about those facts.

(*In re Wayport, Inc. Litig.*, 76 A.3d 296 (Del. Ch. May 1, 2013).)

In sales of public corporations, the SEC's rules promulgated under the **Securities Exchange Act of 1934** govern much of the disclosure that the target company is required to make. For information about these rules, see Practice Note, Proxy Statements: Public Mergers. Beyond these required disclosures, stockholder plaintiffs frequently bring *Revlon* claims alleging that the board of directors of the target company failed to disclose other material information to the stockholders in the proxy statement, such as:

- Management's projections for the company on a stand-alone basis.
- The compensation and potential conflicts of the financial advisor.
- Details of the background to the transaction and how the board reached a decision to approve a sale.

The courts measure each of these claims against the reasonable-investor standard, with the analysis turning on the specific facts of the case.

For further discussion of the requirements for disclosures to stockholders in the context of public merger transactions, see Practice Note, Fiduciary Duties in M&A Transactions: Duty of Disclosure.

In the context of a closely held company, the Court of Chancery has held that the board has no *per se* duty to produce financial statements to the stockholders in the absence of a request by the board of the stockholders to take some action (*The Ravenswood Inv. Co., L.P. v. Winmill & Co. Inc.*, C.A. No. 7048-VCN (Del. Ch. Feb. 25, 2016) (TRANSCRIPT)).

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Essay
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STONE V. RITTER AND THE EXPANDING DUTY OF LOYALTY

Stone v. **Ritter** is the first post-Disney Delaware Supreme Court case articulating the doctrine of good faith. Taking **Stone** v. **Ritter** as a point of departure, we propose a way of understanding how good faith fits within the broader context of Delaware fiduciary duty cases. We see potential cases as arrayed along a continuum from traditional care cases to traditional loyalty cases. In between are cases where director or officer objectivity is impaired, but less so than in traditional loyalty cases. The emerging law of good faith helps courts deal with such cases. Particular clusters of cases develop detailed guidance for certain recurring problematic situations--the adoption of takeover defenses, board responses to shareholder derivative suits, the approval of executive compensation, and so on. At the same time, a more general doctrine of good faith is emerging, one that provides an expressive handle on which to ground future holdings and encourage the development of appropriate norms.

Introduction

After the latest Disney decision, good faith had been poised to take on a new and prominent role in Delaware corporate law. Whether good faith would be treated as an independent duty or as a component of one of the traditional fiduciary duties--loyalty or care--was, however, not clear. In the next case to arise, **Stone** v. **Ritter**, [1] the Delaware Supreme Court quite specifically characterized the duty of good faith as part of the duty of loyalty. The court also threw in a bit of a shocker in **Stone**, characterizing In re Caremark International Inc. Derivative Litigation, [2] until then a paradigmatic duty of care case, as a duty of loyalty case. [3] How can we understand what happened? What now becomes of good faith and the duty ***1770** of care? And, most importantly, how do we understand directors' standards of conduct? When will directors be liable, and when will they not? More specifically, when will section 102(b)(7) [4] exculpation be available?

In this Essay, we argue that the court in **Stone** got it right and, indeed, should have gone further. **Stone** recasts Caremark-type "care" as a species of the duty of loyalty; however, we think the duty of care in toto, including both Caremark-type care and the more generic inattention-type care, is properly understood as largely subsumed by the duty of loyalty. **Stone** opens the door to a more analytically satisfactory articulation of the standard of liability for breach of fiduciary duty. It provides the analytic underpinnings for a continuum of liability where the vast middle ground is good faith, understood as a component of the duty of loyalty.

In this Essay, we propose a way of understanding how good faith fits within the broader context of Delaware fiduciary duty cases. We see potential cases as arrayed along a continuum. At one end are traditional care cases, cases that raise no concern about the objectivity of directors and officers; at the other end are traditional loyalty cases, cases in which the objectivity of directors and officers is clearly impaired and their

ability to profit at the corporation's expense is significant. In traditional care cases, the only conflict between directors and the corporation arises from the natural human tendency not to work as hard or carefully as one might when one is not reaping all the fruits of one's labors. In the traditional loyalty cases, a decision maker has a material pecuniary interest that directly conflicts with that of the corporation--for instance, where a director or officer is selling land to the corporation. In between are cases where director or officer objectivity is impaired, but less so than in traditional loyalty cases. The emerging law of good faith helps courts deal with such cases. We suggest that this law is developing at two levels of abstraction. Particular clusters of cases develop detailed guidance for certain recurring problematic situations--the adoption of takeover defenses, board responses to shareholder derivative suits, the approval of executive compensation, and so on. At the same time, a more general doctrine of good faith is emerging that helps courts deal with more unique circumstances or with emerging problematic business practices; the more general doctrine provides an expressive handle on which to ground future holdings and encourage the development of appropriate norms. The law thus provides guidance, structured and unstructured, as well as flexibility.

This Essay proceeds as follows: In Part I, we discuss the doctrinal background leading up to **Stone**, setting the stage for good faith to assume a prominent role. In Part II, we discuss **Stone**. In Part III, we set forth our view of what fiduciary duty really consists; we show how present duty of care and loyalty cases, and emerging case law on good faith, fit into one continuum. In Part IV, we develop a proposal making use of our continuum ***1771** and our previous work on structural bias, distinguishing stylized classes of cases and establishing procedures for each; we discuss how different types of cases would come out under our proposal.

I. Doctrinal Background

The doctrine of good faith in Delaware corporate law followed a rather twisted path on its way to **Stone** v. **Ritter**. We do not chart that path in detail here. Rather, we highlight some of the main turns and milestones along the way. One could go back further, but we start with the state of Delaware doctrine in the early eighties.

Classically, courts and commentators have identified two types of fiduciary duties of corporate officers and directors: the duty of loyalty and the duty of care. The duty of loyalty applies where managers engage in interested transactions with the corporation.[5] If there is no conflict of interest, then the duty of care applies and defendants receive the protection of the business judgment rule. This two-part understanding of fiduciary duty is enshrined in corporate law casebooks.[6] The Model Business Corporation Act and the American Law Institute Principles of Corporate Governance both codified this understanding.[7]

By the mid-eighties, the classical division between loyalty and care had already been complicated by the introduction of several new standards of care. The Unocal standard applied where a board adopted measures to defend against a hostile takeover.[8] The Revlon standard applied where a board had put its corporation up for sale.[9] The Zapata standard applied where a board had appointed a special litigation committee to review the facts in a pending shareholder derivative lawsuit and the committee had recommended dismissing the suit.[10] We shall include these special standards in our story below. However, those standards apply to limited, albeit important, factual circumstances. For most sorts of corporate decisions, and cases resulting from them, the basic division into loyalty and care still hold.

***1772** So how did good faith come into the picture? There are a variety of sources, but let us focus on one judicial doctrine and one statute.[11] The doctrine is the business judgment rule. This rule shields corporate

managers from judicial scrutiny of their decisions. It does not apply if the plaintiffs can demonstrate that the transaction in question involved a conflict of interest. If the plaintiffs cannot do so, the business judgment presumption comes into play. According to the canonical formulation of the business judgment rule as it took form by the early eighties, it is "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." [12]

This formulation of the business judgment rule provides three ways in which a plaintiff may attempt to rebut the presumption: by showing that the directors either did not act on an informed basis, did not act in good faith, or did not have an honest belief that the action they took was in the best interests of the company. Following the Smith v. Van Gorkom [13] decision, most attention focused on the informed basis prong. The duty of care came to be seen as focused on whether the directors had followed adequate procedures in informing themselves before making a decision. [14]

However, good faith lay dormant within that formulation, and eventually became more important after the legislative response to Van Gorkom. Responding to concerns of rampant director liability and a consequent crisis in Directors' and Officers' (D&O) liability insurance, the Delaware legislature added section 102(b)(7) to the state's corporate law. This section allows corporations to put provisions in their certificates of incorporation that waive personal liability of directors for violations of fiduciary duty. [15] However, liability for several types of fiduciary duty ***1773** violations cannot be waived. Duty of loyalty violations, for example, may not be waived. [16] Crucially, neither may decisions that are not in good faith. [17]

Notice, then, the incentives created for plaintiffs' lawyers by this combination of the business judgment rule and section 102(b)(7). If plaintiffs' lawyers cannot succeed in pleading that a conflict of interest existed, their next best strategy is to plead that the board did not act in good faith. If they can succeed in this argument, two positive consequences follow. First, the defendants lose the protection of the business judgment rule. Second, the defendants will not be able to use section 102(b)(7) to avoid personal liability.

Plaintiffs' lawyers are not stupid, nor are they immune to the effect of incentives. Although it may have taken longer than one might have expected, ultimately the predictable happened: plaintiffs' lawyers started to include arguments that defendant directors had not acted in good faith. This has gradually forced the Delaware courts to begin to consider how to handle such claims.

Case law on good faith grew slowly, though. Moreover, a tension developed in the cases between the Delaware Supreme Court and Chancery Court. [18] In the nineties, Delaware Supreme Court cases started referring to a triad of fiduciary duties: loyalty, care, and good faith. [19] For instance, in Cede & Co. v. Technicolor, Inc. it said,

> To rebut the [business judgment] rule, a shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the triads of their fiduciary duty--good faith, loyalty or due care. [20] However, these cases just referred to good faith; the decisions were not based on that duty, and hence the cases gave no guidance as to what the duty might entail.

The Delaware Chancery Court rather insolently resisted the triad notion. Instead, it located good faith within the duty of loyalty in several cases. [21]

> ***1774** A director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation's best interest. For this reason, the same case that invented the so-called 'triad []' of fiduciary duty also defined good faith as loyalty.

> It does no service to our law's clarity to continue to separate the duty of loyalty from its own essence; nor does the recognition that good faith is essential to loyalty demean or subordinate that essential requirement. There might be situations when a director acts in subjective good faith and is yet not loyal (e.g., if the director is interested in a transaction subject to the entire fairness standard and cannot prove financial fairness), but there is no case in which a director can act in subjective bad faith towards the corporation and act loyally. The reason for the disloyalty (the faithlessness) is irrelevant, the underlying motive (be it venal, familial, collegial, or nihilistic) for conscious action not in the corporation's best interest does not make it faithful, as opposed to faithless. [22] However, even these cases gave little guidance as to what good faith entails.

In the meantime, several cases interpreting the process by which a defendant may invoke section 102(b)(7) confirmed the importance of determining when plaintiffs have successfully pleaded a lack of good faith. Emerald Partners v. Berlin held that section 102(b)(7) "is in the nature of an affirmative defense." [23] Malpiede v. Townson [24] clarified this point. If plaintiffs can succeed in adequately pleading either a loyalty violation or bad faith, then the case cannot be dismissed on the pleadings through invoking section 102(b)(7). If the case survives the pleading stage, then defendants attempting to invoke section 102(b)(7) must prove good faith. [25] Thus, since most Delaware corporations have exculpation clauses in their certificates, whether or not a pleading can survive a motion to dismiss may frequently depend on whether the plaintiffs have adequately pled a lack of good faith.

What, then, do the Delaware courts mean when they refer to action not taken in good faith? [26] The most in-depth answer to that question thus far ***1775** comes from the Disney cases. The key formulation in the Disney cases is as follows: "[T]he concept of intentional dereliction of duty, a conscious disregard for one's responsibilities, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith." [27] In a more detailed elaboration, the court said,

> A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or 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. [28]

The courts, both chancery and supreme, applied this standard to the facts surrounding the hiring, and then the firing, of Michael Ovitz as second-in-command at Disney, and found that the board's conduct was in good faith (or at least, that the plaintiffs had not succeeded in showing that the directors had acted in bad faith). [29] The conduct was fairly close to the edge under this standard insofar as the Chancery Court held

that the pleadings were suggestive enough of bad faith to withstand a motion to dismiss. [30] The case thereby gives us a general, although rather vague, formulation for good faith, and one, albeit important, data point in deciphering how to apply that vague formulation to a complicated fact pattern.

The most direct precedent in the cases leading up to **Stone** is Caremark. [31] Simply put, Caremark employees violated federal and state laws, with the result that Caremark had to pay $250 million in fines and reimbursements. [32] The board neither knew of nor approved the employees' conduct. [33] ***1776** Shareholders sued, alleging that, by failing to adequately monitor employee behavior, the directors violated their fiduciary duty. [34] Chancellor William Allen labeled Caremark as a case alleging a breach of the "duty of attention or care in connection with the on-going operation of the corporation's business." [35] He divided cases involving the "duty to exercise appropriate attention" into two classes. [36] The first class concerns liability that "may be said to follow from a board decision that results in a loss because that decision was ill advised or 'negligent.'" [37] This would seem to be the standard duty of care case, epitomized by Van Gorkom.

The second kind of failure to exercise appropriate attention case "entail[s] circumstances in which a loss eventuates not from a decision but, from unconsidered inaction." [38] Caremark is such a case. These cases raise the question as to whether boards have a duty to install some sort of monitoring system that may catch corporate wrongdoing. Chancellor Allen argued that there is such a duty in contemporary business culture:

> Can it be said today that, absent some ground giving rise to suspicion of violation of law, that corporate directors have no duty to assure that a corporate information gathering and reporting system exists which represents a good faith attempt to provide senior management and the Board with information respecting material acts, events or conditions within the corporation, including compliance with applicable statutes and regulations? I certainly do not believe so. [39] However, only the most egregious of circumstances will violate this duty: "[O]nly 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." [40]

So what sort of fiduciary duty does Caremark represent? The conventional answer has been that it arises under the duty of care. After all, it involved no self-dealing or conflict of interest, the standard hallmarks of the duty of loyalty. Moreover, the question in the case is whether or not the board paid adequate attention to company affairs, the classic duty of care question. Corporate law casebooks include this case in the chapter on the duty of care-- including Chancellor Allen's own casebook. [41]

***1777** But consider the highlighted language above referring to good faith. Good faith language appears elsewhere in the opinion as well. [42] If good faith did represent a separate duty from care, there would be a decent textual basis for characterizing Caremark as a good faith case and not as a care case at all. Thus, before **Stone**, there was some question as to whether the Caremark duty should be classified under the duty of care or the duty of good faith. **Stone** answers the categorization question. It turns out, though, that the answer is actually door number three: the duty of loyalty.

II. Stone v. Ritter

As the Chancery Court said, Stone was "'a classic Caremark claim.'"[43] Employees at AmSouth Bancorporation failed to file suspicious activity reports, as required by banking law.[44] These failures led to fines and civil penalties, and the banking regulators found that AmSouth's legal compliance program was inadequate.[45] Shareholders brought a derivative suit against the board claiming that it had violated its fiduciary duty by failing to institute an adequate program for monitoring legal compliance.[46]

The outcome in the case was not surprising: the Delaware Chancery Court dismissed the claim, and the Delaware Supreme Court affirmed. Caremark duties are deliberately structured to make it extremely hard for plaintiffs to win. Of slightly more interest, the Delaware Supreme Court explicitly upheld the Caremark standard.[47] That is notable, but not a surprise. It confirms what most observers expected.

What did surprise many observers[48] was the Delaware Supreme Court's discussion of where Caremark duties fit analytically within the general structure of fiduciary duty law. The placement matters because AmSouth ***1778** had an exculpation clause. Since there was no plausible self-dealing claim, if Caremark claims were to fall under the duty of care rubric, then under Emerald Partners and Malpiede simple invocation of the exculpation clause would lead to immediate dismissal.[49] However, if a Caremark claim does not fall under the care rubric, then the court must consider whether plaintiffs have adequately pled facts which support a Caremark claim, and not dismiss if they have succeeded in doing so.

The Delaware Supreme Court goes on to closely analyze the reasoning of Caremark. It points to the Chancery Court's repeated reliance on the concept of good faith, in the language quoted above and elsewhere. It thus seems to categorize Caremark as a good faith case. But then the Delaware Supreme Court pushes a step further:

> It is important, in this context, to clarify a doctrinal issue that is critical to understanding fiduciary liability under Caremark as we construe that case. The phraseology used in Caremark and that we employ here-- describing the lack of good faith as a "necessary condition to liability"--is deliberate. The purpose of that formulation is to communicate that a failure to act in good faith is not conduct that results, ipso facto, in the direct imposition of fiduciary liability. The failure to act in good faith may result in liability because the requirement to act in good faith "is a subsidiary element[,]" i.e., a condition, "of the fundamental duty of loyalty." It follows that because a showing of bad faith conduct, in the sense described in Disney and Caremark, is essential to establish director oversight liability, the fiduciary duty violated by that conduct is the duty of loyalty.[50]

Thus, in this paragraph, what had been generally understood to be an instance of the duty of care, indeed perhaps the leading operative instance of the duty of care, became officially an instance of the duty of loyalty.

The court goes on to articulate two doctrinal consequences of this formulation. First, despite being described "colloquially" (by the Delaware Supreme Court, that oh-so-colloquial body), as one of a "triad,"[51] good faith is not an independent fiduciary duty. Only loyalty and care can result in direct liability, while failure to act in good faith only indirectly results in liability. The second consequence is the widening of the duty of loyalty. No longer is loyalty only about "financial or other cognizable fiduciary conflict of interest."[52] It also includes good faith. As the court puts it, quoting one of the Chancery Court cases that had so insolently, but in the end triumphantly, disputed the Delaware Supreme Court's triad, "'A director cannot act loyally

towards the corporation unless she acts in the good faith belief that her actions are in the corporation's best interest.'" [53]

***1779** What does this all mean as a matter of doctrine? As a matter of the English language? As a practical matter for those subject to Delaware law? Those are the questions to which we now turn.

III. Is There Only One Fiduciary Duty?

As we argued in an earlier paper, we think the duty of care was always fundamentally a duty of loyalty:

> Ultimately, directors and officers owe only one fiduciary duty to a corporation--the duty to actively pursue the best interests of the corporation. The duties of loyalty, care, and good faith address differing aspects of this duty. . . . The traditional duty of loyalty addresses situations where directors or officers have material conflicts of interest that are likely to tempt them to favor their own interests over those of the corporation. The duty of care addresses the natural human tendency of directors and officers to not actively exert themselves in pursuing the interests of others. However, on some profound level, it, too, is a breach of the fiduciary duty of loyalty, although the courts do not consider it such--directors and officers are taking leisure that they are not entitled to. [54] There was, and remains, a need to distinguish different sorts of cases to establish different procedural requirements and burdens of proof and persuasion. But those distinctions, important as they may be, do not take away from the critical feature these breaches share: that the directors and officers are taking for themselves something that belongs to the corporation.

The classic duty of loyalty cases involve directors or officers taking for themselves in a very tangible (or at least straightforward) way what should otherwise belong to the corporations--say, a profit from a sale of an asset to the director at a below-market price or from a business opportunity offered to the corporation. What is critical to note, though, is that the corporation is as entitled to the director and officer's time and careful attention as it is to the full profit from the sale of its assets. What it means to be a fiduciary is to "act for the benefit of another person on all matters within the scope of their relationship." [55] The conduct at issue in breaches of loyalty or care (or, as we discuss below, the emerging duty of good faith) ***1780** is not only not "for the benefit of" the officer or director's principal, but it is also at the principal's expense.

Where does the duty of good faith fit in? In our view, the classic formulations of the duty of loyalty were much too limited. A broader formulation was needed to capture conduct that fell outside those bounds but was more than simply generic inattention, for which the highly deferential business judgment standard was used. One can see how, from an analytic distance, making a qualitative distinction between, as one of us says in class when explaining the two duties, snoozing and stealing makes sense. Inattention (snoozing) seems less morally culpable. However, when we consider precisely why a director would be snoozing or otherwise be less than appropriately diligent, we find that in most cases there is something rather more culpable going on, something well captured by the concept of lack of good faith. Indeed, in this regard, consider that generic inattention--simply not looking hard enough or well enough, without a suspect motive--was very rarely what was at issue in the classic duty of care cases. [56] An excellent example is Van Gorkom, [57] (the duty of care case that prompted the legislature to enact section 102(b)(7)), in which the facts strongly implicated excessive deference by the officers and directors to the chief executive officer (CEO).

The duty of good faith thus offers a conceptual framework, under the broader rubric of the duty of loyalty, to encompass cases of culpable conduct not constituting breaches of the duty of loyalty as traditionally conceived. [58] At present, the cases roughly fit into three general categories; other categories may, however, emerge as the jurisprudence develops.

One category is the familiar one of "structural bias"--roughly, again, excessive deference to the other directors or officers. A second category involves cases where director or officer self-interest may be present but the actions at issue involve core corporate concerns, and hence are appropriately not scrutinized to the same extent as cases implicating the traditional duty of loyalty. As we noted in Disney, Good Faith & Structural Bias, [59] courts might reasonably want to discourage classically (and often predominantly) self-interested activities such as hiring one's relatives or having business dealings for one's personal account with a corporation of which one is CEO. But the types of conduct in the class of cases we are concerned with here cannot feasibly be discouraged altogether: directors need, for instance, to consider their responses to takeovers notwithstanding the fact that they may be motivated (in part?) by a desire to entrench themselves in office. For present purposes, we call such cases "suspect ***1781** motive" cases. The third category, "conduct involving illegality," consists of either insufficient monitoring for illegal acts or actually engaging in such acts.

Structural bias is the obvious and paradigmatic category within our framework; it may involve problematic behavior, yet falls short of the traditional duty of loyalty violation. [60] Consider in this regard the fact pattern alleged in Brehm v. Eisner: hasty accession to the CEO's wishes as to hiring and compensating a crony (including as to the crony's termination package and the crony's entitlement thereto). [61] There clearly was no violation of the duty of loyalty as traditionally conceived. Still, the behavior alleged to have occurred violated what the duty of loyalty properly ought to encompass: a duty to critically consider important corporate decisions and not simply rubber-stamp whatever the CEO proposes.

Consider also a decision by a board to backdate officers' stock options. In a recent backdating case, Ryan v. Gifford, [62] the court characterized as "conduct that is disloyal to the corporation and is therefore an act in bad faith" [63] the "intentional violation of a shareholder approved stock option plan, coupled with fraudulent disclosures regarding the directors' purported compliance with that plan." [64] What motivates the other directors to approve such a plan and make such fraudulent disclosures is presumably structural bias. Consider as well a board or committee's decision not to pursue, or to terminate, a shareholder derivative suit (involving board members not involved in the decision), as happened in Zapata. [65]

In the paradigmatic structural bias situation, the director is directly furthering the interests of other directors or officers, when those interests may not be those of the corporation or its shareholders. He is furthering his own interests as well, albeit less directly: He presumably increases the chance he stays on the board or gets some perk (a donation by the company to his favored charity?). He also promotes and perpetuates as a norm the "pernicious golden rule," [66] perhaps building up some claim on reciprocal good treatment in his own capacity as an officer. [67]

There are other situations where the self-interest is more direct, but those situations still do not come under a traditional duty of loyalty analysis. This is the category we call "suspect motives." A board's reaction to takeovers provides an example. [68] Entrenchment, or at least a generous severance ***1782** package, is always a possible motive. However, there can be other self-serving motives. Consider Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc. [69] To defend itself against a hostile takeover by a suitor the board did not like, a

defense perhaps motivated, at least in part, by one self-serving motive--entrenchment--Revlon had issued notes to many of its shareholders in exchange for their shares. [70] The corporation's investment bank opined that the notes would trade at their face value; for this to continue to be true, the covenants contained in the notes had to be in effect. [71] But Revlon waived the covenants in order to attract a bidder they preferred: Forstmann Little. The notes therefore fell in value and Forstmann then promised to support the value of the notes. [72] The directors claimed that favoring Forstmann because Forstmann made this promise constituted good faith: the board was entitled to consider the interests of constituencies other than the shareholders, including the noteholders. [73] The court agreed with the board in principle, but held that there needed to be "rationally related benefits accruing to the stockholders" [74] --which, in this case, there were not. The court clearly thought that the board was not taking into account the interests of the noteholders so much as its own interests in not being sued by the noteholders. It noted that "the fiduciary standards outlined in Unocal . . . impose an enhanced duty to abjure any action that is motivated by considerations other than a good faith concern" for the best interests of the corporation and its shareholders. [75] It held that "the Revlon board could not make the requisite showing of good faith by preferring the noteholders and ignoring its duty of loyalty to the shareholders." [76]

A line of case law sets forth a duty of candor and disclosure owed by the directors and officers. [77] Where does this duty fit into our analysis? The duty paradigmatically arises when directors and officers need shareholder consent, and obtain such consent using disclosures that are false or incomplete. It arises as well when the directors and officers make other false or incomplete disclosures, notwithstanding that they were not doing so to obtain consent. [78]

***1783** In In re Tyson Foods, Inc. Consolidated Shareholder Litigation, [79] a case involving options "spring loading" (options grants made immediately prior to the announcement of good news), the court noted that

> [d]isclosure violations may, but do not always, involve violations of the duty of loyalty. A decision violates only the duty of care when the misstatement or omission was made as a result of a director's erroneous judgment with regard to the proper scope and content of disclosure, but was nevertheless made in good faith. Conversely, where there is reason to believe that the board lacked good faith in approving a disclosure, the violation implicates the duty of loyalty. [80]

One can easily imagine some breaches of the duty of disclosure as being encompassed within the traditional duty of loyalty. Imagine the CEO lying and saying he bought for his personal use at $X property of the corporation worth $X when he knows the true valuation of the property is 10X. But more often, it is not the traditional duty of loyalty but rather structural bias or suspect motives that will be implicated. Consider directors depicting a decision that was a foregone conclusion--rejecting a takeover offer or offering a not-for-cause termination to a crony, for instance--as being extensively and critically considered. Or directors taking a problematic action, such as backdating options or paying a higher severance package than agreed upon to the shareholders, and either not disclosing it or perhaps even falsely depicting the action as appropriate or compliant. [81]

***1784** Our third category within the overall umbrella of good faith is "conduct involving illegality," a "culpable" lack of diligence to prevent illegal acts, such as was alleged in **Stone** itself and in Caremark, or actual commission of illegal acts, the most notable example of which is perhaps Miller v. AT&T. [82]

Here, unlike in all the cases discussed above, a stark divergence between directors' interests and those of shareholders is not in any obvious way what is at issue. Illegal behavior may very well maximize corporate profits; indeed, we would expect that it often would. Paying an illegal bribe in country Z is intended to get you more business in country Z. Often, a company's (non-U.S.) competitors are not subject to antibribery rules, and if the U.S. executive follows the rules, he will lose business to the competitor that can bribe without fear of legal sanction. In some cases, the executive may have made a bad decision in deciding on the illegal conduct-- perhaps he underestimated the risk and cost of sanctions so that the ex ante return on the illegal conduct was less than he thought it would be or even negative. However, why should that not simply be treated as a judgment call given business judgment rule protection, as most other non-self-interested decisions are? [83]

There are several reasons why we might want to treat illegal behavior differently, with less legal deference. For one, the directors' willingness to tolerate or engage in illegal conduct may be a proxy for their willingness to engage in conduct that more directly diverges with the shareholders' interests. Someone who sets out to break the law often displays stealth and a willingness to pursue a more parochial interest over a competing more general interest: their own personal interest over the interests of others, their family or friends' interests over that of strangers, or their corporations' interests over more general social welfare. [84] Those very traits also characterize those prone to steal from their corporations. Also, we may regard illegal acts as contrary to shareholders' interests notwithstanding that they might be in shareholders' pecuniary interests. Shareholders are also citizens, and insofar as laws advance the general social welfare, citizens care about that. A diversified shareholder with small stakes in any one corporation may well find that the public interest predominates over the ***1785** corporate interest. The other possible account, rather less neat from a doctrinal perspective, is that, because corporations are chartered by the state, they owe a duty to the public, which may include the shareholders, not to act illegally. [85] This reason moves us away from the agency account that underlies the rest of this Essay and most current scholarly thinking about corporate law. Since the second reason for caring about illegal action provided above blends into this third reason, we do not need to draw too fine a line as to which better explains why the law has developed as it has. [86]

These reasons are probably enough to explain why directors acting in deliberately illegal ways violate their duty of good faith. However, they do not help us nearly as much in explaining why and when directors who fail to monitor for illegal behavior are violating their duty of good faith. Our best account is this: directors are shirking their responsibility to be vigilant when they, on some metric, "ought" to know what their lack of vigilance might permit; hence, the violation of the duty of good faith. This description seems to fit the allegations made in Caremark and **Stone**, and the standards for liability enunciated therein. The Disney Chancery Court opinion in 2005 quoted Nagy v. Bistricer, [87] as follows:

> If it is useful at all as an independent concept, [good faith's] utility may rest in its constant reminder . . . that, regardless of his motive, a director who consciously disregards his duties to the corporation and its stockholders may suffer a personal judgment for monetary damages for any harm he causes [even if for a reason] other than personal pecuniary interest. [88]

Perhaps another justification for the Caremark line of cases is that internal control systems that monitor illegal behavior tend to overlap with internal control systems that monitor fraudulent behavior. A board that leaves its corporation open to subordinates breaking the law is also likely to be vulnerable to top officers who choose to steal from the corporation. ***1786** Thus, there is at least a hint of structural bias and suspect motives present if one considers, again, why the board might not have had appropriate monitoring systems

in place. These considerations combined with those in the previous paragraph may be enough to justify somewhat more judicial scrutiny than applies in duty of care cases. However, they do not seem to justify much more scrutiny, and indeed that is precisely what we find. **Stone** may have located Caremark on the loyalty side of the loyalty/care divide, but it is very near the border with care. As we have already seen, and emphasize more in the next part, not all cases on the loyalty side of the divide are treated equally--not by a long shot. Some cases within the good faith zone of loyalty receive weak judicial scrutiny, while others receive much more searching scrutiny. Caremark is very much on the weak end of the continuum. Indeed, the categorization of a fact pattern as a Caremark case is almost as good a piece of news for defendants as its categorization as a care case would be: it is very hard for defendants to be held liable in a Caremark case.

It seems, then, that the doctrine of good faith can help us articulate the breach at issue for cases that fall in the middle of the care/loyalty continuum that we have previously hypothesized. [89] Its status as a presumption has worked well at the care end of the continuum. In principle, we do want to make sure that directors are working hard enough and well enough, but we do not want to encourage constant ex post second-guessing of directors by the shareholders. [90] Where plaintiffs cannot articulate anything other than a problematic decision made after what seems to them like less-than-thorough process, good faith should indeed be presumed, especially given the incentives plaintiffs have to bring suits whenever a decision turns out badly whatever the merits at issue. While, as we have noted, not working hard or well enough constitutes a taking of leisure to which one is not entitled, and hence could be characterized as a breach of the duty of loyalty, the situations are sufficiently distinct that a different label--care rather than loyalty--seems appropriate, as does, of course, a deferential doctrine, with its substantive backstop for truly egregious decisions, namely, waste. But--and this is key-- until recently, many cases couched as care cases in fact implicated something else--not loyalty as loyalty had traditionally been characterized, but something culpable nevertheless, often because of structural bias or suspect motives. Consider in this regard the following quote from the Disney Chancery Court opinion in 2005:

> It is precisely in this context--an imperial CEO or controlling shareholder with a supine or passive board--that the concept of good faith may prove ***1787** highly meaningful. The fiduciary duties of care and loyalty, as traditionally defined, may not be aggressive enough to protect shareholder interests when the board is well advised, is not legally beholden to the management or a controlling shareholder and when the board does not suffer from other disabling conflicts of interest, such as a patently self-dealing transaction. Good faith may serve to fill this gap and ensure that the persons entrusted by shareholders to govern Delaware corporations do so with an honesty of purpose and with an understanding of whose interests they are there to protect. [91]

In addition to the other benefits discussed above, the good faith doctrine also potentially allows us to expand and rationalize the class of intermediate standards--now consisting principally of Unocal, regarding takeover threats; Revlon, regarding corporations that have been put up for sale; and Zapata, regarding decisions not to pursue a derivative suit [92] --into a more coherent framework.

We should address here two criticisms of this increased judicial use of the good faith concept in corporate law. One criticism is that the scope of good faith liability is uncertain, and will thus increase litigation and litigation costs. [93] That is true, but we do not see it as a decisive objection. The increase in uncertainty is limited by two factors. First, as we shall argue in the next part, the courts have already articulated more fine-tuned and precise standards of review for a variety of specific situations that would be encompassed within the good faith framework, reducing uncertainty in those situations. Second, the Disney definition of

good faith is of relatively limited scope and draws on intent language that is common in many areas of law. It thus does not provide much comfort for plaintiffs who want to go too far in expanding the scope of the law, and the long history of similar language imports a fair amount of guidance for lawyers interpreting the cases. Moreover, any sort of legal standard can be criticized as yielding greater uncertainty and litigation costs than would a precise rule. However, sometimes standards make sense as a way to give courts flexibility to respond to complicated fact patterns and new circumstances. We argue in the next part that this is one of those times. All this being said, we should be clear at this juncture that our conception of good faith may very well go beyond that used by the Disney court. As we discuss in the next part, the good faith cases closest to the care end of the continuum may contemplate less intentionality than is suggested in the Disney case. But the jurisprudence still likely will, and should, develop in a sufficiently cautious and incremental manner that defendants should not have to see their burdens in defending against derivative cases suddenly increase appreciably.

***1788** Stephen Bainbridge has raised another objection to **Stone**, based on the remedy rule that results from the doctrinal placement of good faith.[94] He argues that stripping away ill-gotten gains is the traditional remedy for loyalty violations, but by extending the duty of loyalty to cases where the defendants have not received any material pecuniary gain at the expense of the corporation, this remedy will become unavailable. This will create "a conceptually difficult task of crafting appropriate remedies"[95] and also create a doctrinal conflict with Cede's holding that harm causation is not a required element.[96] We are not convinced by this objection. Although it is true that rescission or rescissionary damages are the standard form of remedy in standard loyalty cases, the Delaware Supreme Court has already held that in loyalty cases the court may "fashion any form of equitable and monetary relief as may be appropriate."[97] Thus, rescissionary damages are not the exclusive remedy available. Compensatory damages may also be used, as appropriate. Indeed, in the general law of agency, both compensatory damages and recovery of the value received wrongfully by the principal are valid remedies.[98] Thus, if there is no ill-gotten gain in any particular case, that simply means that one of several possible damage measures is not available in that case. The other measures may still be used.

We now turn to a discussion of our framework.

IV. Our Proposal

Stone v. **Ritter** forges a path to what we think is the right answer. The terminology does not line up completely with ours, but we think analytically the framework and result are the same.

Director duties, and breaches thereof, fall along a continuum. There are stylized cases at both ends, where the procedures have been well developed. Care, with its very strong deference, which essentially translates into "plaintiff loses" (and even if he did not lose, there would be exculpation), is at one extreme. Traditional loyalty, where the defendant has to show good process (in the form of approval by disinterested and fully informed directors, shareholders, or both) or, failing that, very good substance (that is, "entire" or "intrinsic" fairness), is at the other extreme. Of most interest here are the cases that fall between these extremes, where we think good faith will increasingly become part of the doctrinal story.

In dividing up the cases along this continuum, we can think at varying levels of abstraction (see Figure 1). At the very highest level, there is just one fiduciary duty--to pursue faithfully and diligently the best interests of the corporation and its shareholders. Below this level of abstraction, we ***1789** can see the continuum of cases as divided into the two traditional categories, care and loyalty. Why divide the cases this way? As we discuss above and below, we put into the care category circumstances where we want courts to largely avoid

scrutinizing board behavior, such that it is extremely unlikely that directors will ever be held personally liable. [99] Loyalty cases deserve at least a bit of (and sometimes quite a bit of) a closer look from courts.

One level of abstraction below that, we divide the loyalty category into two parts. One part, at the extreme end, is traditional loyalty cases, where directors or officers have a pecuniary material interest that conflicts with the interests of the corporation. The other part is good faith. This includes the intermediate cases that fall between traditional care and traditional loyalty. Why is this division of the broad loyalty category useful? Cases presenting facts that fall in the traditional loyalty category clearly deserve close scrutiny from some sort of independent decision maker, be it independent directors, shareholders, or the courts. We have well-established rules for these sorts of cases. Good faith is a more nebulous category. It includes many different kinds of factual circumstances, united by the fact that we have some reason to be concerned about director objectivity (hence, they are not care cases), but the stark concerns of traditional conflicts of interest are not present (hence, they are not traditional loyalty cases). It is thus useful to distinguish good faith from traditional loyalty.

If we then descend one more level of abstraction, we find that the good faith region in turn subdivides at present into a variety of different factual circumstances and related standards of review. The more specific standards of review give structured guidance to courts, corporations, and their counselors where the facts fall within the scope of those specific standards. The general backdrop of good faith gives courts flexibility to deal with new circumstances that do not fit within better defined standards of review, and to develop new specific standards for other sorts of cases where appropriate. [100]

Let us look more closely at each part of this continuum. At one end is generic inattentiveness: The directors did not give the attention that was due, for no purposive or intentional reason. The directors are taking from the corporation something that belongs to the corporation--their due consideration and time. Still, given the ever-present concern that directors might become too risk averse and too tied up in ex post shareholder second-guessing, and, given the broad grant of authority to the board, the present regime seems appropriate in cases where nothing more can be shown.

***1790** Consider in this regard Kamin v. American Express Co. [101] Kamin involved a substantive decision to forego $8 million in tax savings in order to avoid $25 million in accounting losses. [102] Tax savings are real monetary savings; accounting losses or gains are merely paper losses or gains. A robust debate exists as to whether markets value accounting earnings; the best academic findings indicate that the answer is no, but market practitioners typically say and apparently believe the answer is yes. [103] Indeed, there is considerable evidence that they "put their money where their mouths are," paying considerable amounts (admittedly, of others' money, but certainly, of their own time) to structure transactions to obtain the more desirable accounting treatment. [104] The directors in Kamin listened, in good faith, to the market practitioners, who told them the market would react very badly to a $25 million loss and not nearly so badly to a decision not to save $8 million in taxes. [105] This seems like precisely the sort of decision directors should not be second-guessed on: good faith here was appropriately presumed and, apparently, present. [106]

Another reason exists for favoring considerable deference in cases of simple generic inattention. The main result of imposing liability would probably not be more diligent decisions. Rather, it would probably be a full employment act for lawyers and other advisers (and, as is commonly observed, perhaps a smaller contingent of people willing to serve as directors), as proper process was painstakingly documented. Telling directors to work harder and better--and face liability if they do not--scarcely seems to provide sensible incentives.

At the other end of the continuum is traditional loyalty, where one or more directors, officers, or controlling shareholders has a material pecuniary interest in a decision that conflicts with the interests of the corporation and its shareholders in that decision. Here, a transaction involving a conflict of interest is presumptively invalid, unless it is validated through one of three methods. A defendant in a loyalty case must show that (1) the transaction was approved by disinterested and independent directors; (2) the transaction was approved by disinterested shareholders; or (3) the transaction was entirely fair to the corporation. [107] ***1791** Any of these prongs involves a fair degree of scrutiny by the court of the process by which a transaction was approved, and at least some scrutiny of the substance of the transaction as well, albeit usually only minimal substantive scrutiny in the first two prongs.

In between, there is a vast middle ground. In our earlier paper, we located structural bias within a middle ground between traditional loyalty and care. [108] We also discussed certain stylized types of cases in which courts had adopted procedures that were intermediate, neither at the "pure care" end nor at the "pure loyalty" end. Here, we propose that the middle ground actually is lack of good faith. At one end of the middle ground itself is simple lack of good faith; at the other is affirmative bad faith. [109]

The best formulation to date for this middle ground is the analysis in the Disney cases described above. [110] However, if some recurring set of circumstances is important and unique enough, courts may elaborate the general good faith analysis into a more specific doctrine for those circumstances. Moreover, articulation of the broad contours of the doctrine may very well change, especially as the role of differing levels of intentionality becomes more developed in the jurisprudence. Thus, over time the broad good faith part of the continuum becomes more complicated and highly elaborated.

Figure 1, at the lowest level of abstraction, locates some of the key cases within the good faith middle ground. Cases closer to the care end of the continuum receive less scrutiny from courts; cases closer to the loyalty end receive more scrutiny. This continuum is not necessarily smooth everywhere; there are notches and bumps. A big bump occurs at the boundary between care and loyalty, where a notably higher degree of judicial scrutiny kicks in. The placement of a case on this continuum reflects the courts' rough judgment as to how much risk of biased decision making is present within a given type of circumstance. The three categories we considered in Part III all enter into this analysis. The more structural bias that is present, the further toward the loyalty end a fact pattern will tend to fall. Similarly, the more suspect motives appear to be present, the further toward the loyalty end one will find a case. The subcategory of other culpable conduct, conduct involving illegality, also moves a case toward the loyalty end, much more so where the illegality reflects intentional behavior by directors or officers. That being said, even a failure to monitor as in Caremark moves the case toward the loyalty end--after all, it moves the case from care to loyalty, given **Stone**. Weighed against these factors is the need to allow corporations to choose freely whether or not to enter into certain kinds of transactions. We do not claim the considerations ***1792** we have mentioned occupy the field completely; there may currently be more, or there may come to be more. That said, let us consider the range of cases within the good faith portion of the continuum.

On the left, closest to the duty of care, is Caremark, i.e., cases where the board allegedly failed to put in place adequate systems to monitor illegal behavior by subordinate employees. As long as the board has put something in place, courts are almost certain to defer to the board in such cases, absent further suspicious facts. [111] In Caremark cases there is just a whiff of structural bias and suspect motives, and while there is illegal behavior, it is by subordinates, not by the board or top officers; hence, there is little reason for concern about biased decision making in such cases.

Moving a bit toward the loyalty end, we have placed Levine v. Smith. [112] Levine deals with judicial review of decisions by boards to reject a demand made by plaintiffs prior to instituting a derivative action. Such cases involve greater concern about structural bias and suspect motives, insofar as directors are making a decision about whether a case against themselves and/or their fellow directors should continue. Indeed, one might well argue that this situation should be placed further toward the loyalty end of the continuum than we have put it here. In this regard, some states' courts impose a high level of scrutiny for such decisions because of the structural bias concerns. [113] However, Delaware has chosen to extend business judgment rule protection to such cases, although the board's decision can still be scrutinized for good faith. [114] In our earlier article, we suggest that Delaware's review of such decisions can and should be stiffened somewhat through the use of good faith analysis. [115]

Moving again toward the loyalty end in Figure 1, but still relatively close to the care end, we find Disney. Disney articulates a general standard for good faith, but it also deals with a recurring and important fact pattern, namely, executive compensation decisions. Executive compensation is receiving a great deal of attention, and the Delaware courts are seeing more ***1793** compensation cases. [116] We expect that, as the courts see more such cases, they will develop more specific guidance. This may take the form of articulating a specific standard of review, but even if not, the courts through accumulated cases will give more guidance as to what sorts of procedure are likely to insulate compensation decisions, and what sorts of procedure will raise red flags. Executive compensation implicates significant concern about structural bias, which is why a fair degree of scrutiny is warranted. On the other hand, compensation decisions are unavoidable, frequent, and recurrent, so an overly strict standard of judicial scrutiny would be too much of an intrusion into board decision making; hence, Disney remains not far from the care end of the continuum.

Moving further along in Figure 1, we find the two main change of control categories, Unocal and Revlon. [117] Changes in corporate control inherently raise structural bias and suspect motive concerns, as directors and officers want to protect their positions (and each others' positions) within the corporation. This is why the Delaware courts give more scrutiny in such cases than they would if they were using business judgment deference. However, changes in corporate control and defenses against such changes both have strong justifications in some circumstances. Courts are not very good at distinguishing where control changes should be encouraged or discouraged, and to whom control should be transferred if there is to be a change. It is therefore inadvisable for courts to very closely scrutinize a board's decision in these matters. The courts have tried to strike a balance between these competing considerations, crafting standards of review that put such cases in the middle of the continuum.

Getting close to the loyalty end, we find Zapata. [118] Recall that Zapata involves derivative suits where shareholder demand was excused, the board set up a special litigation committee to review the merits of the suit, and the committee recommended dismissal. [119] Here, the structural bias concerns are very strong, the ability of the court to judge the wisdom of the committee's decision is better than usual, and the business needs to use such committees are relatively weak. Hence, there is not much reason to defer to such decisions, and Delaware courts do not.

Closest to the loyalty end of the continuum is Blasius Industries, Inc. v. Atlas Corp. [120] This case, as later described by the Chancery Court, involves board actions taken with the intent of precluding shareholder action: "[T]he incumbent board attempted to appoint new members at the eleventh hour to preclude shareholders from filling those seats by electing a ***1794** hostile acquirer's candidates." [121] State of Wisconsin Investment Board v. Peerless, a subsequent case applying Blasius, involved a board's adjournment of a shareholder meeting when it became clear that a shareholder vote would approve a

measure that management opposed. [122] Once Blasius is invoked, the judicial scrutiny is no less searching than in traditional loyalty cases themselves--perhaps even more searching. [123]

We think this structure tracks fairly closely the Delaware case law on fiduciary duty as it has developed. The structure is of course not perfect; however, it does succeed in giving the courts flexibility to address new situations as they arise while still providing corporations and their counsel a fair degree of guidance in many kinds of recurring situations. It also does, we think, a sensible job of singling out for greater judicial scrutiny those kinds of cases that are likely to be more problematic.

Our structure and its conceptual underpinnings also serve another important function. Extralegal forces--norms and reputation--play a very strong role in the behavior of corporate actors. [124] Delaware courts are clearly aware of this function, and employ it to encourage behavior they find desirable but that would be difficult to address more directly through law itself. [125] Consider in this regard much of the language in Caremark. In approving the settlement in that case, Chancellor Allen expressly acknowledged that the plaintiffs almost certainly would have lost. Still, he took the occasion to articulate what directors ought to be doing in cases presenting Caremark-type issues. Similarly, consider the language in the Chancery Court opinion in Disney. [126] The court takes pains to describe the deficiencies in the board of directors' process, characterizing it as "fall [ing] far short of what shareholders expect and demand from those entrusted with a fiduciary position," [127] while nevertheless ruling in their favor. Finally, consider also the case of Kahn v. Sullivan, [128] where the court approved a settlement of an action against Occidental Petroleum for having built a museum with corporate funds to house the art collection of the CEO and ***1795** one percent shareholder. [129] Approving the settlement, the court nevertheless noted its displeasure with the board:

> [T]he Settlement in the Court's opinion leaves much to be desired.
>
> The Court's role in reviewing the proposed Settlement, however, is quite restricted. If the Court was a stockholder of Occidental it might vote for new directors, if it was on the Board it might vote for new management and if it was a member of the Special Committee it might vote against the Museum project. But its options are limited . . . . [130]

The court is telling corporate actors how it thinks they should behave--and corporate actors listen. Consider in this regard the rush to abide by "Caremark duties" after the case was decided. Corporations employ well-paid advisers to tell them how to avoid conduct that might trigger liability. Activist shareholders publicize their corporations' deviations from what the activists view as best practices, and bring shareholder resolutions to advance their views. Indeed, as jurisprudence on good faith develops, we would expect norms of conduct to develop as well, which will almost certainly contain a penumbra beyond what law can directly reach.

Conclusion

In the classic formulation of the duty of loyalty, when a director breaches her duty of loyalty, she takes for herself or her relations or affiliates what should otherwise be the corporation's. Classic duty of loyalty cases paradigmatically involve a conveyance of money or assets between the director or officer and the corporation. It is clear, given that the director or officer can have a role in setting the terms of the

conveyance, that the terms could be biased in favor of the director or officer. Thus, once there is such a conveyance, the terms are necessarily scrutinized, as is the process by which the terms were reached.

Classic duty of care cases also involve a director taking for herself something which should otherwise be the corporation's: her attention and diligence. But clearly, we cannot apply the same level of scrutiny to all corporate decisions as we are willing to apply to decisions where the director or officer had a clear opportunity to benefit herself at the expense of the corporation. Thus, the duty of care jurisprudence has developed with considerable deference to directors and officers.

The difficulty has been, though, that, as a general matter, if a case did not fall under the narrow loyalty definition, it too often was treated as invoking only the duty of care--notwithstanding some indication that the directors were not properly doing their jobs, and that the omission was not simple neglect. Consider why directors might not have given adequate attention to ***1796** a decision. In many, and perhaps most, cases, inadequate attention will mean something in the family of rubber stamping on account of structural bias, something that does essentially implicate loyalty concerns.

Thus, we have had a class of cases in which the directors are somehow culpable--but how were we to characterize that culpability in the context of existing fiduciary duty jurisprudence? The issue always mattered, but came to matter even more after the enactment of section 102(b)(7). Before, liability for breach of duty of care was simply exceedingly unlikely. After section 102(b)(7), it became impossible. Something clearly needed to occur--a recognition and delineation of a middle-ground category of culpable act or omission, as has now occurred in **Stone** v. **Ritter**.

That middle ground is the realm of good faith. Cases that fall into this realm will get greater judicial scrutiny than care cases, and create some risk of liability. How much more scrutiny and risk will depend on how much risk of director misbehavior is present in a particular kind of context. For frequently recurring contexts--takeover defenses, derivative actions, executive compensation, and so on--the courts will continue to develop more specialized rules that respond to the challenges arising within each context. Beyond that, the courts will, and should, continue to use good faith to address new sorts of corporate governance issues that arise with evolving business practices that raise questions of structural bias, suspect motivation, or other sorts of concerns. Courts should continue as well to use their "bully pulpit" to set forth and encourage the development of norms and best practices that may effectively influence directors as much as, or more than, the fear of legal liability.

Figure 1: A Continuum of Cases

TABULAR OR GRAPHIC MATERIAL SET FORTH AT THIS POINT IS NOT DISPLAYABLE

Footnotes

a1 Professor of Law, University of Minnesota Law School.

aa1 Professor of Law, University of Minnesota Law School. We are grateful for the helpful comments we received at a square-table presentation at the University of Minnesota and at the Canadian Law and Economics Association conference.

1 911 A.2d 362, 370 (Del. 2006).

2 698 A.2d 959 (Del. Ch. 1996).

3 **Stone**, 911 A.2d at 370.

4 Del. Code Ann. tit. 8, § 102(b)(7) (2001).

5 See Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993) ("A director is considered interested where he or she will receive a personal financial benefit from a transaction that is not equally shared by the stockholders. Directorial interest also exists where a corporate decision will have a materially detrimental impact on a director, but not on the corporation and the shareholders." (citations omitted)).

6 See Jesse H. Choper et al., Cases and Materials on Corporations 74-179 (6th ed. 2004); William A. Klein et al., Business Association: Cases and Materials on Agency, Partnerships and Corporations 328-412 (6th ed. 2006); D. Gordon Smith & Cynthia A. Williams, Business Organization: Cases, Problems, and Case Studies 395-524 (2004).

7 See Principles of Corporate Governance: Analysis and Recommendations pt. IV (duty of care), pt. V (duty of loyalty) (1994); Model Bus. Corp. Act § 8(C), (F) (2005).

8 See Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985).

9 See Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986).

10 See Zapata Corp. v. Maldonado, 430 A.2d 779, 781 (Del. 1981).

11 Several other statutory provisions, beyond that discussed in the text, are notable for their use of the good faith concept as well. These include Del. Code Ann. tit. 8, § 141(e) (2001) (good faith reliance on records and opinions), Del. Code Ann. tit. 8, § 144 (good faith board or shareholder approval of interested transactions), and Del. Code Ann. tit. 8, § 145 (indemnification allowed for liability incurred as a result of actions in good faith, thus apparently disallowing indemnification for liability incurred as a result of actions lacking good faith).

12 Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

13 488 A.2d 858 (Del. 1985).

14 In this regard, Van Gorkom has been disparaged as encouraging directors to formalistically follow and document "due procedure," without regard to, and perhaps at the expense of, critical and rigorous decision making. On Delaware corporate law's emphasis on process, see Claire A. Hill & Erin Ann O'Hara, A Cognitive Theory of Trust, 84 Wash. U. L. Rev. 1717, 1789-90 (2006).

15 Section 102(b)(7) quickly became part of the story told by the many corporate law scholars who thought director liability had no teeth--as some said, an outside director has more chance of being hit by lightning than being found liable for breaching his fiduciary duty. See Bernard Black, Brian Cheffins & Michael Klausner, Outside Director Liability, 58 Stan. L. Rev. 1055, 1139-40 (2006); Margaret M. Blair & Lynn A. Stout, Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law, 149 U. Pa. L. Rev. 1735, 1791 (2001). Interestingly, Delaware Chancellor Leo Strine and Professor Lynn Stout now think directors are too responsive to pressures from public shareholders, and that firms are therefore increasingly going private. See Leo E. Strine, Jr., Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance, 33 J. Corp. L. 1 (2007); Lynn Stout, Investors Who Are Too Bolshy for Their Own Good, Fin. Times, Apr. 23, 2007, at 9.

16 See Del. Code Ann. tit. 8, § 102(b)(7)(i).

17 See id. § 102(b)(7)(ii).

18 See Christopher M. Bruner, Good Faith, State of Mind, and the Outer Boundaries of Director Liability in Corporate Law, 41 Wake Forest L. Rev. 1131, 1155 (2006).

19 See Emerald Partners v. Berlin, 726 A.2d 1215, 1221 (Del. 1999); Malone v. Brincat, 722 A.2d 5, 10 (Del. 1998); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993).

20 Cede, 634 A.2d at 361.

21 See Guttman v. Huang, 823 A.2d 492, 506 (Del. Ch. 2003); Nagy v. Bistricer, 770 A.2d 43, 48 n.2 (Del. Ch. 2000).

22 Guttman, 823 A.2d at 506 n.34 (citations omitted).

23 Emerald Partners v. Berlin, 726 A.2d 1215, 1223 (Del. 1999).

24 780 A.2d 1075, 1092-96 (Del. 2001).

25 See supra note 11.

26 In recent years a number of scholars have written articles considering the meaning and implications of Delaware's growing good faith jurisprudence. In addition to the sources cited elsewhere in this Essay, these include Robert Baker, In re Walt Disney: What It Means to the Definition of Good Faith, Exculpatory Clauses, and the Nature of Executive Compensation, 4 Fla. St. U. Bus. Rev. 261 (2005); Matthew R. Berry, Does Delaware's Section 102(b)(7) Protect Reckless Directors from Personal Liability? Only If Delaware Courts Act in Good Faith, 79 Wash. L. Rev. 1125 (2004); Carter G. Bishop, A Good Faith Revival of Duty of Care Liability in Business Organization Law, 41 Tulsa L. Rev. 479 (2006); Sarah Helene Duggin & Stephen M. Goldman, Restoring Trust in Corporate Directors: The Disney Standard and the "New" Good Faith, 56 Am. U. L. Rev. 211 (2006); Tara L. Dunn, The Developing Theory of Good Faith in Director Conduct: Are Delaware Courts Ready to Force Corporate Directors to Go Out-of-Pocket After Disney IV?, 83 Denv. U. L. Rev. 531 (2005); Sean J. Griffith, Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence, 55 Duke L.J. 1 (2005); Sean J. Griffith & Myron T. Steele, On Corporate Law Federalism: Threatening the Thaumatrope, 61 Bus. Law. 1 (2005); Janet E. Kerr, Developments in Corporate Governance: The Duty of Good Faith and Its Impact on Director Conduct, 13 Geo. Mason L. Rev. 1037 (2006); John L. Reed & Matt Neiderman, "Good Faith" and the Ability of Directors to Assert § 102(b)(7) of the Delaware Corporation Law as a Defense to Claims Alleging Abdication, Lack of Oversight, and Similar Breaches of Fiduciary Duty, 29 Del. J. Corp. L. 111 (2004); David Rosenberg, Making Sense of Good Faith in Delaware Corporate Fiduciary Law: A Contractarian Approach, 29 Del. J. Corp. L. 491 (2004); Hillary A. Sale, Delaware's Good Faith, 89 Cornell L. Rev. 456 (2004); C.G. Hintmann, Note, You Gotta Have Faith: Good Faith in the Context of Directorial Fiduciary Duties and the Future Impact on Corporate Culture, 49 St. Louis U. L.J. 571 (2005); Filippo Rossi, Making Sense of the Delaware Supreme Court's Triad of Fiduciary Duties (June 22, 2005) (unpublished manuscript), available at http:// ssrn.com/abstract=755784.

27 In re Walt Disney Co. Derivative Litig., 906 A.2d 27, 62 (Del. 2006) (quoting the Chancery Court opinion).

28 Id. at 67 (quoting the Chancery Court opinion).

29 Id. at 72. We consider in the text accompanying note 109, infra, whether 'not in good faith' and 'bad faith' are, or should be, equivalent.

30 In re Walt Disney Co. Derivative Litig., 825 A.2d 275 (Del. Ch. 2003).

31 In re Caremark Int'l, Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996).

32 Id. at 960-61.

33 Id. at 965 ("No senior officers or directors were charged with wrongdoing in the Government Settlement Agreement or in any of the prior indictments.... [T]he United States stipulated that no senior executive of Caremark participated in, condoned, or was willfully ignorant of the wrongdoing....").

34 Id. at 964.

35 Id. at 967.

36 Id.

37 Id.

38 Id. at 968.

39 Id. at 969 (emphasis added).

40 Id. at 971 (emphasis added).

41 William T. Allen, Reinier Kraakman & Guhan Subramanian, Commentaries and Cases on the Law of Business Organization 282-92 (2d ed. 2007).

42 E.g., Caremark, 698 A.2d at 967 ("[C]ompliance with a director's duty of care can never appropriately be judicially determined by reference to the content of the board decision that leads to a corporate loss, apart from consideration of the good faith or rationality of the process employed." (emphasis omitted)); id. at 968 ("Indeed, one wonders on what moral basis might shareholders attack a good faith business decision of a director as 'unreasonable' or 'irrational.' Where a director in fact exercises a good faith effort to be informed and to exercise appropriate judgment, he or she should be deemed to satisfy fully the duty of attention." (emphasis omitted)); id. ("Learned Hand correctly identifies the core element of any corporate law duty of care inquiry: whether there was good faith effort to be informed and exercise judgment."); id. at 970 ("[A] director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists....").

43 **Stone** v. **Ritter**, 911 A.2d 362, 364 (Del. 2006) (quoting the Chancery Court opinion).

44 Id. at 365.

45 Id. at 365-66.

46 Id. at 364.

47 Id. at 365, 369.

48 See, e.g., BusinessAssociationsBlog, http:// www.businessassociationsblog.com/lawandbusiness/comments/**stone**_v_**ritter**_ directors_caremark_oversight_duties/ (Jan. 3, 2007); Posting of Gordon Smith to Conglomerate, http://www.theconglomerate.org/2007/01/good_faith_care.html (Jan. 3, 2007).

49 See supra notes 23-24 and accompanying text.

50 **Stone**, 911 A.2d at 369-70.

51 Id. at 370.

52 Id.

53 Id. (quoting Guttman v. Huang, 823 A.2d 492, 506 n.34 (Del. Ch. 2003)).

54 Claire A. Hill & Brett H. McDonnell, Disney, Good Faith & Structural Bias, 32 J. Corp. L. 833, 855 (2007).

55 Black's Law Dictionary 658 (8th ed. 2004) (defining "fiduciary" as "[a] person who is required to act for the benefit of another person on all matters within the scope of their relationship; one who owes to another the duties of good faith, trust, confidence, and candor"). The doctrine comes from agency law. See Restatement (Third) of Agency § 1.01 cmt. e (2006). This doctrine has been put to use not only in corporate law, but in many other areas as well, most notably in trust law. Some legal relationships are considered fiduciary relationships and are governed by some general common law doctrines that essentially reflect the Black's Law Dictionary's definition. See generally Tamar Frankel, Fiduciary Duties, in The New Palgrave Dictionary of Economics and the Law 127 (Peter Newman ed., 1998).

56 And of course, after the Delaware legislature enacted section 102(b)(7), allegations that simply amounted to generic inattention became rarer still.

57 Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

58 For an argument that loyalty should be broadly conceived to include an element of affirmative devotion to the well-being of the corporation, see Lyman Johnson, After Enron: Remembering Loyalty Discourse in Corporate Law, 28 Del. J. Corp. L. 27 (2003).

59 Hill & McDonnell, supra note 54, at 852.

60 See Julian Velasco, Structural Bias and the Need for Substantive Review, 82 Wash. U. L.Q. 821 (2004).

61 Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

62 918 A.2d 341 (Del. Ch. 2007).

63 Id. at 358.

64 Id.

65 Zapata Corp. v. Maldonado, 430 A.2d 779, 781 (Del. 1981).

66 We coined this term to describe directors who are also officers of other corporations who defer in their capacities as directors because, as officers, they would want a deferential board. Hill & McDonnell, supra note 54, at 838.

67 For more on structural bias, see Velasco, supra note 60.

68 See, e.g., Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

69 506 A.2d 173 (Del. 1986).

70 Id. at 177-79, 182-83.

71 Id. at 177.

72 Id. at 178.

73 Id.

74 Id. at 182.

75 Id. at 181.

76 Id. at 182.

77 See generally Lawrence A. Hamermesh, Calling off the Lynch Mob: The Corporate Director's Fiduciary Disclosure Duty, 49 Vand. L. Rev. 1087 (1996) (discussing the duty generally).

78 See id. at 1146 (discussing another type of case, in which a director is acquiring stock from an outside, public stockholder). We do not discuss this type of case because no action even purportedly on behalf of the corporation is involved.

79 919 A.2d 563 (Del. Ch. 2007).

80 Id. at 597-98.

81 One interesting recent case involves the severance payment made to Carly Fiorina, former chief executive officer, when she left Hewlett Packard (HP). In Indiana Elec. Workers Pension Trust Fund, IBEW v. Dunn, HP was sued by shareholders who claimed that Fiorina's severance payment was more than the 2.99-times-salary-and-

bonus threshold above which HP's severance policy stated HP would seek shareholder approval. No. C-06-01711 RMW, 2007 WL 1223220 (N.D. Cal. Mar. 1, 2007). One claim made by the shareholders rested on the duty of disclosure--that "defendants breached their fiduciary duty to disclose because HP did not disclose in its 2004, 2005, and 2006 proxy statements that it never intended to honor the Severance Policy or provisions of the Severance Program." Indiana Elec. Id. at *11. The case was dismissed, but the plaintiffs were granted leave to amend their pleadings, and they have done so. Id. at *12.

Shareholders have also brought suits criticizing corporate disclosure alleging that the action at issue was disclosed but not properly characterized--paradigmatically, that directors took some questionable action and did not characterize it as such. Courts have rejected those sorts of claims, saying boards do not have to engage in self-flagellation. See, e.g., In re Walt Disney Co. Derivative Litig., 731 A.2d 342 (Del. Ch. 1998). In Disney, the Chancery Court stated,

The Plaintiffs in this action attempt to convert their flawed derivative claim against Disney for paying Ovitz severance benefits to a disclosure claim. First, they claim that the information was germane to shareholder consideration of the five directors' re-election because shareholders would consider important within the total mix the fact that these directors approved such extravagant waste. That assertion runs afoul of the rule against self-flagellation:

Delaware law does not, however, require a proxy statement to impugn a director's character or draw negative inferences from his past business practices. It only requires a summary of his credentials and his qualifications to serve on the board as well as a description of any conflicts of interest. Nothing in our law requires a masochistic litany of management minutiae.

Id. at 377 (quoting Wolf v. Assaf, No. C.A. 15339, 1998 WL 326662, at *5 (Del. Ch. June 16, 1998)). It is interesting to consider whether a good faith framework might be able to revive some of these claims where the disclosure was drafted, as legal disclosures frequently are, to convey the fact of what was done while somewhat obscuring the spirit.

82 507 F.2d 759 (3d Cir. 1974).

83 Stephen Bainbridge has made this point in criticizing **Stone**. Stephen M. Bainbridge et al., The Convergence of Good Faith and Oversight 36-38 (UCLA Sch. of Law, Law & Economics Research Paper Series, Research Paper No. 07-09, 2007), available at http://ssrn.com/abstract=1006097.

84 Note that whether the corporation's interest is parochial or general depends on the context and what it is being compared to: it is more general than one individual's interest but more parochial than society's interests.

85 A related reason could be that fiduciaries are classically supposed to be honest and honorable, and simply breaking the law could be seen as running afoul of that characterization. See Frankel, supra note 55, at 129 ("Fiduciary law vests in entrustors the legal right to rely on the honesty of their fiduciaries by imposing on fiduciaries a corresponding duty of loyalty and other specific duties to deter dishonesty.").

86 There is one line of cases suggesting that damages from illegal conduct would only be the amount by which the company suffered from the conduct net of what it gained. But that damage formula is based on a New York decision that has subsequently been criticized. See Principles of Corporate Governance: Analysis and Recommendations § 7.18(c) cmt. e (1994) ("In effect, derivative actions seeking to hold corporate officials accountable for fines imposed on the corporation as a result of knowing criminal antitrust violations were dismissed because the plaintiff could not prove that the crime did not pay. The continued authority of these decisions is questionable after the New York Court of Appeals' subsequent decision in Diamond v. Oreamuno, 24 N.Y.2d 494 (1969), which stressed that the deterrent role of the derivative action excused the necessity of proving a loss to the corporation and also held that an intangible loss to the corporation might arise from adverse publicity and stigmatization.").

87 770 A.2d 43, 48 n.2 (Del. Ch. 2000).

88 In re Walt Disney Co. Derivative Litig., 907 A.2d 693, 754 n.453 (Del. Ch. 2005).

89 Lyman Johnson also suggests that good faith can provide doctrinal support for the duty to affirmatively devote oneself to the corporation's interest, something Johnson calls the "affirmative" or "devotion" side of loyalty. See Johnson, supra note 58, at 69 n.245.

90 See generally Stephen M. Bainbridge, The Business Judgment Rule as Abstention Doctrine, 57 Vand. L. Rev. 83 (2004).

91 Disney, 907 A.2d at 760 n.487.

92 See supra notes 8-10 and accompanying text.

93 See Bainbridge et al., supra note 83, at 34; see also Andrew S. Gold, A Decision Theory Approach to the Business Judgment Rule: Reflections on Disney, Good Faith, and Judicial Uncertainty, 66 Md. L. Rev. 398 (2007).

94 Bainbridge et al., supra note 83, at 28-31.

95 Id. at 31.

96 Id. at 28-31.

97 Weinberger v. UOP, Inc., 457 A.2d 701, 714 (Del. 1983).

98 Restatement (Second) of Agency § 407 (1957).

99 See generally Bainbridge, supra note 90.

100 See Melvin A. Eisenberg, The Duty of Good Faith in Corporate Law, 31 Del. J. Corp. L. 1, 30-31 (2006).

101 383 N.Y.S.2d 807 (App. Div. 1976).

102 Id. at 809.

103 One of us wrote an article discussing this debate. See generally Claire A. Hill, Why Financial Appearances Might Matter: An Explanation for 'Dirty Pooling' and Some Other Types of Financial Cosmetics, 22 Del. J. Corp. L. 141 (1997).

104 Id. at 145-46 n.12 (discussing the AT&T/NCR transaction).

105 Kamin, 383 N.Y.S.2d at 811-12.

106 This being said, we should note that, in Hill & McDonnell, supra note 54, at 860 n.135, we argue that Kamin may not actually have been a straightforward care case. The alternative explanation invokes structural bias, suspect motives, and/or even straightforward self-interest: the directors were motivated by a compensation measure, applicable to the compensation of four of the twenty-member board, based on accounting earnings rather than the report by market experts as to the likely effect of the accounting loss.

107 See Del. Code Ann. tit. 8, § 144 (2001).

108 Hill & McDonnell, supra note 54, at 855.

109 On the distinction between lack of good faith and bad faith, see id. at 856-57. See also Elizabeth A. Nowicki, The Unimportance of Being Earnest: Reflections on Director Liability and Good Faith (Aug. 1, 2006) (unpublished manuscript), available at http://www.ssrn.com/abstract=921668.

110 See supra notes 27-30 and accompanying text.

111 Bainbridge voices concern about the consequences of **Stone** in instances where a board has adopted no compliance system whatsoever. He believes it may inappropriately let boards off where they are unaware of the duty to have such a system, and that it may inappropriately find boards liable where they have carefully

weighed the costs and benefits and decided such a system is not worth it. Bainbridge et al., supra note 83, at 42-48. We doubt that in this day and age any public corporation board can plausibly fit into the former, uninformed category--the duty to have a compliance system is simply too pervasive, particularly post-Sarbanes-Oxley. As for the latter category, a consequence of **Stone** is indeed that any board will feel it must have some sort of legal compliance system in place--and that is presumably an intended effect, and one that is defensible, as we argued above. See supra notes 82-90 and accompanying text. Moreover, the need for intentional behavior may be muted as the good faith doctrine develops; an additional ground for finding the totally unaware board liable may therefore come to exist.

112 591 A.2d 194 (Del. 1991).

113 See, e.g., Alford v. Shaw, 358 S.E.2d 323 (N.C. 1987).

114 See, e.g., Grimes v. Donald, 673 A.2d 1207 (Del. 1996).

115 Hill & McDonnell, supra note 54, at 859.

116 See, e.g., Desimone v. Barrows, 924 A.2d 908 (Del. Ch. 2007); In re Tyson Foods Consol. Shareholder Litig., 919 A.2d 563 (Del. Ch. 2007); Ryan v. Gifford, 918 A.2d 341 (Del. Ch. 2007).

117 See supra notes 8-9 and accompanying text.

118 See supra note 10 and accompanying text.

119 See supra note 10 and accompanying text.

120 564 A.2d 651 (Del. Ch. 1988).

121 State of Wis. Inv. Bd. v. Peerless Sys. Corp., No. Civ. A. 17637, 2000 WL 1805376, at *12 (Del. Ch. Dec. 4, 2000).

122 Id. at *1.

123 A recent case refines, and arguably somewhat alters, the Blasius standard. See Mercier v. Inter-Tel., 929 A.2d 786 (Del. Ch. 2007). Blasius seemed to suggest that it would be very hard to postpone a shareholder vote to stop a result the management did not like; Mercier suggests that such a postponement may be not quite so hard.

124 Johnson also stresses the interplay between the judicial loyalty rhetorical and extrajudicial norms. See Johnson, supra note 58, at 29.

125 See E. Norman Veasey & Christine T. Di Guglielmo, What Happened in Delaware Corporate Law and Governance From 1992-2004? A Retrospective on Some Key Developments, 153 U. Pa. L. Rev. 1399, 1406 (2005) (describing "an important genre of Delaware decision making" that "raises questions or teaches without imposing liability" thereby providing "guidance to the corporate world to conform to best practices without the downside of actually imposing personal liability").

126 In re Walt Disney Co. Derivative Litig., 907 A.2d 693 (Del. Ch. 2005).

127 Id. at 763.

128 594 A.2d 48 (Del. 1991).

129 Id. at 51-52.

130 Id. at 58 n.23 (citing Sullivan v. Hammer, CIV. A. No. 10823, 1990 WL 114223, at *4 (Del. Ch. Aug. 7, 1990), aff'd sub nom, Sullivan, 594 A.2d 48).

End of Document

Supreme Court Rule 84.04

84.04. Briefs--Contents

Currentness

(a) Contents. The brief for appellant shall contain:

(1) A detailed table of contents, with page references, and a table of cases (alphabetically arranged), statutes, and other authorities cited, with reference to the pages of the brief where they are cited;

(2) A concise statement of the grounds on which jurisdiction of the review court is invoked;

(3) A statement of facts;

(4) The points relied on;

(5) An argument, which shall substantially follow the order of the points relied on; and

(6) A short conclusion stating the precise relief sought.

(b) Jurisdictional Statement. Bare recitals that jurisdiction is invoked "on the ground that the case involves the validity of a statute" or similar statements or conclusions are insufficient as jurisdictional statements. The jurisdictional statement shall set forth sufficient factual data to demonstrate the applicability of the particular provision or provisions of article V, section 3, of the Constitution upon which jurisdiction is sought to be predicated. For example: "The action is one involving the question of whether the respondent's machinery and equipment used in its operations in removing rock from the ground are exempt from the state sales tax law as being machinery and equipment falling within the exemption provided by section 144.030.3(4), RSMo, and, hence, involves the construction of a revenue law of this state."

(c) Statement of Facts. The statement of facts shall be a fair and concise statement of the facts relevant to the questions presented for determination without argument. All statements of facts shall have specific page references to the relevant portion of the record on appeal, i.e., legal file, transcript, or exhibits. If the citation is to the system-generated legal file, it shall include the system-generated appeal document number and page

number (e.g., D6 p. 7). If the portion cited is contained in the appendix, a page reference to the appendix shall also be included (e.g., D6 p. 7; App 9).

(d) Points Relied On.

(1) Where the appellate court reviews the decision of a trial court, each point shall:

(A) Identify the trial court ruling or action that the appellant challenges;

(B) State concisely the legal reasons for the appellant's claim of reversible error; and

(C) Explain in summary fashion why, in the context of the case, those legal reasons support the claim of reversible error.

The point shall be in substantially the following form: "The trial court erred in [*identify the challenged ruling or action*], because [*state the legal reasons for the claim of reversible error*], in that [*explain why the legal reasons, in the context of the case, support the claim of reversible error*]."

(2) Where the appellate court reviews the decision of an administrative agency, rather than a trial court, each point shall:

(A) Identify the administrative ruling or action the appellant challenges;

(B) State concisely the legal reasons for the appellant's claim of reversible error; and

(C) Explain in summary fashion why, in the context of the case, those legal reasons support the claim of reversible error.

The point shall be in substantially the following form: "The [*name of agency*] erred in [*identify the challenged ruling or action*], because [*state the legal reasons for the claim of reversible error, including the reference to the applicable statute authorizing review*], in that [*explain why, in the context of the case, the legal reasons support the claim of reversible error*]."

(3) In an original writ proceeding, each point shall:

(A) State what relief the petitioner or relator seeks from the appellate court;

(B) Identify the action that the petitioner or relator challenges;

(C) State concisely the legal reasons for the challenge to respondent's action; and

(D) Explain in summary fashion why, in the context of the case, those legal reasons support the challenge.

For an action in prohibition, the point shall be in substantially the following form: "Relator is entitled to an order prohibiting Respondent from [*describe challenged action*], because [*state the legal reasons for the challenge*], in that [*explain why, in the context of the case, the legal reasons support the challenge*]." For other remedial writs, the introductory language should be altered appropriately.

(4) Abstract statements of law, standing alone, do not comply with this rule. Any reference to the record shall be limited to the ultimate facts necessary to inform the appellate court and the other parties of the issues. Detailed evidentiary facts shall not be included.

(5) Immediately following each "Point Relied On," the appellant, relator, or petitioner shall include a list of cases, not to exceed four, and the constitutional, statutory, and regulatory provisions or other authority upon which that party principally relies.

(6) If a party asserts error relating to damages, the party may assert its material effect on the judgment, including that the judgment is inadequate or excessive, in the same "Point Relied On."

(e) Argument. The argument shall substantially follow the order of "Points Relied On." The point relied on shall be restated at the beginning of the section of the argument discussing that point. The argument shall be limited to those errors included in the "Points Relied On." For each claim of error, the argument shall also include a concise statement describing whether the error was preserved for appellate review; if so, how it was preserved; and the applicable standard of review.

If a point relates to the giving, refusal or modification of an instruction, such instruction shall be set forth in full in the argument portion of the brief. Long quotations from cases and long lists of citations should not be included.

All factual assertions in the argument shall have specific page references to the relevant portion of the record on appeal, i.e., legal file, transcript, or exhibits. If the citation is to the system-generated legal file, it shall include the system-generated appeal document number and page number (e.g., D6 p. 7). If the portion cited is contained in the appendix, a page reference to the appendix shall also be included (e.g., D6 p. 7; App 9).

(f) Respondent's Brief. The respondent's brief shall include a detailed table of contents, a detailed table of authorities, and an argument in conformity with this Rule 84.04.

If the respondent is dissatisfied with the accuracy or completeness of the jurisdictional statement or statement of facts in the appellant's brief, the respondent's brief may include a jurisdictional statement or statement of facts.

The argument portion of the respondent's brief shall contain headings identifying the points relied on contained in the appellant's brief to which each such argument responds. The respondent's brief may also include additional arguments in support of the judgment that are not raised by the points relied on in the appellant's brief.

(g) Reply Briefs. The appellant may file a reply brief but shall not reargue points covered in the appellant's initial brief.

(h) Appendix. A party's brief shall be accompanied by a separate appendix containing the following materials, unless the material has been included in a previously filed appendix:

(1) The judgment, order, or decision in question, including the relevant findings of fact and conclusions of law filed in a judge-tried case or by an administrative agency;

(2) The complete text of all statutes, ordinances, rules of court, or agency rules claimed to be controlling as to a point on appeal; and

(3) The complete text of any instruction to which a point relied on relates.

An appendix also may set forth matters pertinent to the issues discussed in the brief such as copies of exhibits, excerpts from the written record, and copies of new cases or other pertinent authorities.

The appendix shall have a separate table of contents.

The pages in the appendix shall be numbered consecutively beginning with page A1. The inclusion of any matter in an appendix does not satisfy any requirement to set out such matter in a particular section of the brief.

An appendix to a brief on appeal, regardless of the number of pages it contains, shall be filed as a separate document.

(i) Cross Appeals. If a cross appeal is filed, the plaintiff in the court below shall be deemed the appellant for purposes of this Rule 84.04, unless the parties otherwise agree or the court otherwise orders. The appellant's initial brief shall be filed as otherwise provided in this Rule 84.04 and Rule 84.05. The respondent's initial brief shall contain the issues and argument involved in the respondent's appeal and the response to the brief of the appellant. The appellant may file a second brief in response to the respondent's brief setting forth respondent's appeal and in reply to the respondent's brief opposing appellant's appeal. The respondent may file a reply brief in reply to appellant's response to the issues presented by respondent's appeal. The briefs otherwise shall comply with Rule 84.06. No further briefs shall be filed without leave of the court.

Credits

(Adopted June 13, 1979, eff. Jan. 1, 1980. Amended July 27, 1979; amended June 1, 1993, eff. Jan. 1, 1994; Sept. 28, 1993, eff. Jan. 1, 1994; May 15, 1998, eff. Jan. 1, 1999; May 27, 1999, eff. Jan. 1, 2000; May 26, 2000, eff. Jan. 1, 2001; Dec. 15, 2000, eff. July 1, 2001; May 16, 2001, eff. July 1, 2001; May 23, 2001, eff. Jan. 1, 2002; Jan. 28, 2002, eff. Jan. 1, 2003; June 21, 2005, eff. Jan. 1, 2006; Dec. 18, 2007, eff. July 1, 2008; June 28, 2011, eff. Jan. 1, 2012; May 30, 2012, eff. Jan. 1, 2013; May 19, 2016, eff. Jan. 1, 2017; June 30, 2017, eff. Jan. 1, 2018.)

Editors' Notes

Relevant Additional Resources

Additional Resources listed below contain your search terms.

LAW REVIEW AND JOURNAL COMMENTARIES

Effective appellate briefs. A. P. **Stone**, Jr., 15 J. of Mo. Bar 80 (1959).

Relevant Notes of Decisions (11)

View all 3471

Notes of Decisions listed below contain your search terms.

IN GENERAL

In general

Justice demands that case be correctly and speedily determined, and this cannot be completely and surely done unless causes appealed and submitted to appellate courts are properly briefed. Jacobs v. **Stone** (Sup.1957) 299 S.W.2d 438. Appeal And Error 766

Page references, in general

It was duty of appellant to distinctly point out alleged errors of trial court and to show that he was prejudiced by rulings alleged to be erroneous, and to make specific reference to pages in transcript on appeal which disclosed basis for contentions of error in trial court's rulings. Jacobs v. **Stone** (Sup.1957) 299 S.W.2d 438. Appeal And Error 758.1; Appeal And Error 760(1)

STATEMENT OF FACTS

In general, statement of facts

A statement in an appellate brief which does not afford appellate court an immediate, complete, and unbiased understanding of facts and which does not fairly present facts is pernicious in conveying distorted and imperfect impression and renders appeal subject to dismissal. **Ritter** v. **Ritter** (App.1965) 394 S.W.2d 78. Appeal And Error 766

---- Child custody and welfare proceedings, decision on the merits, statement of facts

Former Rule 83.05 (now, this rule) subjecting appeal to dismissal where statement in appellant's brief did not fairly present the facts was waived where the custody and hence welfare of infant children was involved. **Ritter** v. **Ritter** (App.1965) 394 S.W.2d 78. Appeal And Error 766

POINTS RELIED ON

In general, points relied on

Single point relied on that groups multiple, disparate claims is multifarious, does not comply with appellate rule governing content of briefs, and generally preserves nothing for appellate review. **Stone** v. **Stone** (App. W.D. 2014) 450 S.W.3d 817. Appeal and Error 758.3(3)

Sufficiency of evidence, points relied on--In general

Nothing was presented for review by point relied upon that predicated error on trial court's failure to give withdrawal instruction on issue of dairy farmers' damages and loss due to prematurely culled cows and hypothesized that farmers failed to provide competent evidence regarding proper measures of damages; point failed to suggest what evidence should have been presented, or why evidence presented was insufficient. MFA Co-op. Ass'n No. 86 v. **Stone** (App. S.D. 1998) 971 S.W.2d 885. Appeal And Error 758.3(8)

---- Sufficiency of points, instructions

Nothing was presented for review by point relied upon that predicated error on trial court's failure to give withdrawal instruction on issue of dairy farmers' damages and loss due to prematurely culled cows and hypothesized that farmers failed to provide competent evidence regarding proper measures of damages; point failed to suggest what evidence should have been presented, or why evidence presented was insufficient. MFA Co-op. Ass'n No. 86 v. **Stone** (App. S.D. 1998) 971 S.W.2d 885. Appeal And Error 758.3(8)

Point relied upon did not present issue for review when point indicated that instruction given did not address issue of feed manufacturer's duty to dairy farmers, who claimed their cattle were harmed by manufacturer's feed, but point failed to set forth what duty was owed, provided no indication as to how instruction failed to instruct on that subject, and did not show how proffered instruction adequately covered matter. MFA Co-op. Ass'n No. 86 v. **Stone** (App. S.D. 1998) 971 S.W.2d 885. Appeal And Error 758.3(8)

Directed verdict, points relied on--In general

Where appellant's brief contained no concise statement of why it was contended that trial court erred in sustaining motion for directed verdict, appellant's printed argument did not refer to facts of case, nor show in what way any particular fact was overlooked or misconstrued by trial court, or in what way trial court incorrectly applied law to facts in ruling that appellant had failed to make out case for jury, and statement of facts and printed argument were devoid of any specific page reference to transcript, appeal could not be maintained in absence of showing of requirement in interest of justice that, having failed to comply with former Rule 83.05 (now, this rule) concerning appellate briefs appeal should not have been dismissed. Jacobs v. **Stone** (Sup.1957) 299 S.W.2d 438. Appeal And Error 766

Multiple counts, points relied on

Court of Appeals disregard widow's violation of rule by raising second subject in single point on appeal, as analysis did not need to address that inappropriate second subject. Hansen v. **Ritter** (App. W.D. 2012) 375 S.W.3d 201, rehearing and/or transfer denied. Appeal and Error 758.3(3); Appeal and Error 766

A statement of a point relied on violates rule when it groups together multiple contentions not related to a single issue. Hansen v. **Ritter** (App. W.D. 2012) 375 S.W.3d 201, rehearing and/or transfer denied. Appeal and Error 758.3(3)

V.A.M.R. Rule 84.04, MO R RCP Rule 84.04
Current with amendments received through April 1, 2019.

End of Document

2008 WL 653143 (Del.Supr.) (Appellate Brief)
Supreme Court of Delaware.

Paddy WOOD, Plaintiff below, Appellant,
v.
Charles C. BAUM, et al., Defendants below, appellees,
and
MUNICIPAL MORTGAGE & EQUITY, LLC, a Delaware corporation, Nominal defendant below, Appellee.

No. 621,2007.
February 28, 2008.

On Appeal from the Court of Chancery
The Honorable Stephen P. Lamb
C.A. NO. 2404-VCL

Appellees' Answering Brief

Morris, Nichols, Arsht & Tunnell LLP, Kenneth J. Nachbar (# 2067), 1201 N. Market Street, P.O. Box 1347, Wilmington, DE 19899-1347, (302) 658-9200, Attorneys for Appellees.

Of Counsel:, Clifford Chance US LLP, James B. Weidner, 31 West 52nd Street, New York, NY 10019, Jon R. Roellke, Anthony R. Van Vuren, 2001 K Street, NW, Washington, DC 20006.

***i** TABLE OF CONTENTS

***iii** TABLE OF AUTHORITIES

Cases

Statutes And Other Authorities

***1** NATURE OF THE PROCEEDINGS

This is an appeal from the Chancery Court's decision dismissing Plaintiff's Amended Shareholder Derivative Complaint ("Complaint") against Municipal Mortgage & Equity, LLC ("MMA" or the "Company") and

each of the ten current members of its Board and one former director (collectively, "Director Defendants") for failure to sufficiently plead demand futility. [1]

Plaintiff filed her original complaint on September 7, 2006, alleging that the Director Defendants breached their fiduciary duties by, among other things, authorizing related party transactions and failing to oversee the Company's charitable contributions and certain financial statements and accounting practices. (Al). On November 29, 2007, the Defendants moved to dismiss that complaint, establishing that Plaintiff had failed to sufficiently allege demand futility. (A4). On March 7, 2007, in lieu of responding to the merits of the motion to dismiss, Plaintiff filed her amended Complaint pursuant to Delaware Chancery Rule 15(aaa). (A12-93). Because the amended Complaint did not cure the fundamental pleading deficiencies of its predecessor, the Defendants moved to dismiss it by motions dated March 21, 2007 and April 10, 2007. [2]

After reviewing the parties' briefs and hearing oral argument, the Chancery Court ruled from the bench and dismissed the Complaint for failure to allege particularized facts sufficient to establish that demand would have been futile. (B62-63). The Chancery Court found that "though the complaint is 80-some pages long and is a model of prolixity, it fails to state any basis on which the Court could reasonably conclude that the demand futility standard is met." (B63).

Recognizing the important public policy served by the requirement of a pre-suit demand under Delaware law, the Chancery Court explained that it is not ***2** "a court of first resort" (B59) and that "a board has to be given a chance to respond to problems" where a shareholder "has an issue about the way the company is conducting its business and thinks that [it is] in violation of law or in breach of some duty." (B37-38). Rejecting Plaintiff's demand futility argument that the Director Defendants confront personal liability because they knew or should have known about the Company's allegedly improper conduct, the Chancery Court held that "nothing alleged in [the] complaint [] would suggest that the claims [Plaintiff is] seeking to bring are matters that themselves have come to the board's attention." (B33).

The Chancery Court also noted the Complaint's allegations that detail the Board's oversight of the Company's reporting and information systems and controls. (See, e.g., A132-36). In reference, for example, to the restatement of earnings process the Company is undertaking at the direction of the Board, the Chancery Court observed: "[W]hat I see is the board of directors and its audit committee in particular [] engaged in what seems to be a pretty searching inquiry into the company's internal controls and its financial statements.... [G]iven that, why would I assume that [] those same people, if asked to look into the things that you allege here, wouldn't look into them and couldn't do so in the exercise of their business judgment?" (B51).

Based on these and its other observations as reflected in the oral argument transcript, the Chancery Court concluded that the Complaint does not allege facts showing that the Director Defendants "are sufficiently threatened with personal liability and, in particular, under the strict standard for personal liability that this [Company's] operating agreement sets forth, that they would be unable to receive and consider a demand in the exercise of their business judgment." (B62-63).

By order dated November 2, 2007, the Chancery Court confirmed this ruling and ordered that the Complaint be dismissed. (B66).

***3 SUMMARY OF ARGUMENT**

Plaintiff's sole contention in this appeal is the familiar "incantation" that demand would have been futile because it would have required the Director Defendants to sue themselves. (OB 8). This "bootstrap argument" has "been made to and dismissed by other courts," *Aronson v. Lewis,* 473 A.2d 805, 818 (Del. 1984) - recently by this Court in ***Stone*** *v.* ***Ritter****,* 911 A.2d 362, 367 (Del. 2006) - and it requires that Plaintiff plead with particularity a *non-exculpated* claim that the Director Defendants consciously engaged in fraudulent or illegal conduct or committed a bad faith breach of their contractual oversight duties. Far from meeting that standard, Plaintiff all but ignores the broad statutory and contractual immunity that protects the Director Defendants against liability for the acts and omissions alleged in the Complaint. And much of what Plaintiff pleads confirms, rather than refutes, that the Board has in good faith discharged its fiduciary duties. The Chancery Court's dismissal of the Complaint should be affirmed.

1. Denied. Plaintiff pleads no facts showing that any Director Defendant, much less a majority of them, had the requisite "culpable state of mind" necessary to state a claim based on allegedly "fraudulent or illegal conduct" or a "bad faith" failure of oversight. Although she summarily asserts that the Director Defendants "affirmatively took actions which hid the extensive risks under which the Company has operated" and "caus[ed] the Company to engage in numerous non bona-fide, improper, related party transactions" and "issue false financial statements" (OB 3), she does not allege what, if any, specific involvement any Director Defendant had in allegedly implementing or reviewing the challenged transactions and financial statements. Nor are there any particularized allegations showing that any Director Defendant had actual knowledge that any of the challenged transactions or accounting practices were improper.

Contrary to Plaintiff's assertion, the requisite scienter cannot be inferred from conclusory allegations that the Board "approved" or "authorized" the allegedly improper transactions and financial statements. (OB 12-13). Mere approval of a transaction or financial statement (even one that later proves to be improper or inaccurate) does not equate to conscious wrongdoing. As this Court has taught, accepting Plaintiff's assertion to the contrary would render "the demand requirements of our law [] meaningless, leaving the clear mandate of Chancery Rule 23.1 devoid of its purpose and substance." *Aronson,* 473 A.2d at 814. Thus, even assuming that Plaintiff adequately alleged board approval (which she failed to do), and that she can show that the alleged acts and omissions were, in hindsight, somehow improper or illegal (which she cannot), ***4** she does not allege any facts showing that the Director Defendants knew the transactions or reporting practices were improper at the time they were allegedly approved. Absent such facts, and none here is pled, Delaware law does not excuse the failure to make a pre-suit demand based on alleged director liability.

Plaintiff also incorrectly asserts that all of the Director Defendants consciously abdicated their oversight duties by disregarding "red flags" that, if heeded, would have shown that the alleged transactions and financial reporting were improper. (OB 4, 13-14). She fails to plead any such cognizable "red flags" and, certainly, none that the Board knowingly ignored. Plaintiff, in fact, does not dispute that before the filing of this lawsuit, no one ever suggested to any member of the Board that the alleged accounting practices and transactions were somehow improper. (B34). Unlike the cases on which Plaintiff relies, no employee or officer, no regulator, no court, no accountant, no tax lawyer, no borrower or creditor, and certainly no other shareholder is alleged to have given the Board any indication whatsoever that the practices and transactions alleged in the Complaint were in any way improper. In short, not one of the so-called "red flags" Plaintiff identifies alleges particularized facts showing that (a) someone advised a majority of the Director Defendants that the alleged acts or omissions were somehow improper; and (b) those Director Defendants knowingly ignored *any* such warnings. (A310-12; B37).

2. Denied. Plaintiff argues that the Chancery Court "erred by making findings of fact and failing to draw reasonable inferences in Plaintiffs favor." (OB 4). Specifically, she asserts that the Chancery Court: (a)

improperly "imputed findings of fact" that the Board's Audit Committee kept itself informed about the Company's valuation of certain assets; and (b) failed to infer that the Board was advised about the results of a "failed auction" that allegedly demonstrated that the valuations were not accurate. (OB 26-29). But the Chancery Court did nothing more than apply the presumption to which director action is entitled under Delaware law. *Aronson,* 473 A.2d at 812 (absent well-pleaded facts to the contrary, directors are presumed to have "acted on an informed basis in good faith and in the honest belief that the action taken was in the best interest of the company."). And it correctly declined to draw inferences that were neither reasonable nor sufficiently supported by particularized allegations about what any Director Defendant, much less a majority of them, knew or was told with respect to the matters alleged in the Complaint. Moreover, even if the Chancery Court drew the inferences Plaintiff argues are supported by her Complaint, those inferences do not establish a substantial likelihood of personal liability sufficient to meet her demand futility pleading burden.

***5** 3. The Complaint's pleading deficiencies are the direct result of Plaintiffs admitted failure to use the "tools at hand" and make a books and records demand for materials that would have confirmed that her core factual allegations are false and that all her claims lack merit. (B54-56). Rather than investigate her claims through such a request or by making the requisite pre-suit demand, Plaintiff knowingly ignored available information, hoping that a Delaware court would hold the Board strictly liable for transactions and asset valuations with which an admittedly uninformed shareholder disagrees. Delaware law does not, and should not, recognize any such notion of director liability.

***6** STATEMENT OF FACTS

A. MMA's Board And The Exculpation Provisions In The Company's Operating Agreement

MMA is a Delaware limited liability company with its principal place of business in Baltimore, Maryland. As described in the Complaint: "MMA provides debt and equity financing to various parties, invests in tax-exempt bonds and other housing-related debt and equity investments, and is a tax credit syndicator that acquires and transfers low-income housing tax credits." (A13; ¶ 2). MMA has a ten-member Board of Directors. (A13-16; ¶¶ 3-14).

Aside from her "personal liability" argument, Plaintiff does not contest in this appeal that a majority of the Board is otherwise independent and disinterested with respect to the matters alleged in the Complaint. Plaintiff has, for example, abandoned her contention below that demand should be excused because the entire Board is "dominated and controlled" by Director Defendants Falcone and Joseph or because every member of the Board lacks independence based on alleged "intertwining relationships through ongoing business relationships and leadership positions in both social and economic organizations." (A210-13). Plaintiff does not, in this appeal, challenge the Chancery Court's rejection of those allegations. (B49; A120-21, A296-98). [3]

Plaintiff also does not dispute that MMA's Amended and Restated Certificate of Formation and Operating Agreement ("Operating Agreement") provides that "[n]o director or officer of the Company shall be liable, responsible, or accountable in damages or otherwise to the Company or any Shareholders for any act or omission performed or omitted by him or her, or for any decision, except in the case of fraudulent or illegal conduct of such person." (A170; § 8.1(a)). [4] This exculpation and its corollary indemnification provision [5] are pursuant to § 18-1101 of the Delaware LLCA which allows a limited liability company to "provide for the limitation or elimination of any and all ***7** liabilities... for breach of duties (including fiduciary duties) of

a [director].” 6 Del. C. § 18-1101(e). The only limitation the LLCA imposes on a limited liability company's ability to exculpate its directors is a contractual one: it “may not limit or eliminate a bad faith violation of the implied contractual covenant of good faith and fair dealing.” 6 Del. C. § 18-1101(e).

B. The Transactions And Accounting Practices Alleged In The Complaint

Plaintiff claims that all of the Director Defendants confront personal liability based on their alleged approval of, or failure to adequately oversee: (a) the Company's charitable contributions that beneficiaries allegedly used to service debt held by MMA (A30-34; ¶¶ 47-56; OB 12-13); (b) the financial reporting of certain assets in accordance with an accounting statistic under the amended Statement of Financial Accounting Standard 115 (“FAS 115”) referred to in the Complaint as “other than temporarily impaired” (A35-59; ¶¶ 57-109; OB 13-14); and (c) the potential tax implications of certain allegedly “improper asset transactions” that earned “enormous profits” for the Company and its shareholders. (A59-71; ¶¶ 110-46; OB 13-14). [6]

The Complaint does not allege any facts about when, how, or under what circumstances any individual member of the Board considered or reviewed these alleged transactions or accounting practices. Instead, with respect to six of the Board's ten current members (all of whom are outside directors), the only specific facts Plaintiff alleges is that they served on the Board and that some of them also served on the Board's Audit Committee. (A13-15; ¶¶ 4, 6, 8, 10-12). Plaintiff alleges that a seventh outside director, Defendant Fred N. Pratt, Jr., owns unspecified limited partnership and other interests in unidentified entities “related to [MMA's] affordable housing investment business” but does not ***8** explain how or in what way any such interests are related to the matters alleged in the Complaint. (A15; ¶ 13). And Plaintiff's only specific allegations with respect to the eighth outside director, Richard O. Berndt, is that he is the Managing Partner of a law firm that provided legal services to MMA in 2005. (A13; ¶5). [7]

The only specific allegations about the two remaining and allegedly “interested” current directors, Defendants Joseph and Falcone, are that: (a) Falcone is MMA's Chief Executive Officer and President and Joseph is its Chairman of the Board; (b) both directors own MMA stock and receive base compensation and performance bonuses payable in cash and/or restricted stock and stock options; (c) both directors had some non-specific ownership interest in properties that allegedly served as collateral on bonds purchased and sold by MMA; and (d) Joseph, through some unspecified means, allegedly “controlled” certain entities that were borrowers on bonds that MMA bought and sold. (A14; ¶¶ 7, 9). [8]

C. Facts Admitted, Or Not Alleged, In The Complaint Or Conceded At Oral Argument

With respect to the alleged improper valuation of “non-performing assets,” the Complaint does not allege when, how, or under what circumstances any Director Defendant considered or reviewed the Company's application of FAS 115. Rather, Plaintiff acknowledges that the Company believed it could “recover full value” (at maturity or otherwise) for those assets and she admits that such an assessment is a proper consideration in correctly applying FAS 115. (A38-41; ¶¶ 66-67). And although Plaintiff contends that the Company should have also considered other factors, she does not allege that the Company actually failed to recover full value on any such asset. It alleges only that the Company withdrew an “auction” offering to

sell some of those assets when it concluded ***9** that the bids to purchase them were inadequate. (A51-52; ¶ 88). This allegation comports with the Company's stated intent, acknowledged in the Complaint, to hold such assets until it could recover their full value. (A57; ¶ 104).

With respect to the Company's alleged charitable contributions, the Complaint does not identify any facts indicating when, how, or under what circumstances any Director Defendant considered or reviewed those transactions. Instead, the Complaint acknowledges that the Company made charitable contributions to separate legal entities that, in turn, made their own decisions about how to distribute or use the donations they received. (A32-A34; ¶¶ 51, 53, 55). The Complaint also does not allege any specific facts showing that any of MMA's charitable contributions were actually used by their recipients to service debt. Nor does it allege any facts showing that any Director Defendant knew that any donations were being used for such purposes or that any such use would have been improper.

With respect to the allegedly "improper asset transactions," the Complaint does not identify any facts indicating when, how, or under what circumstances any Director Defendant considered or reviewed those transactions. Although the Complaint alleges that the Board "reviewed, authorized and affirmed" the transactions because they were allegedly "related party transactions" the Board was obliged to approve under the Company's Operating Agreement (A61; ¶ 116), it does not set forth any specific facts concerning the procedures and processes through which the Board was allegedly deficient in conducting any such review. And it does not contain any particularized allegations indicating that any member of the Board approved the transactions knowing that they were improper or in breach of the Board's fiduciary duties. Instead, Plaintiff admits that the alleged transactions were not fraudulent (B48- 49) and that they earned "enormous profits" for MMA's shareholders. (A60; ¶ 110). And Plaintiff pleads no particularized allegations indicating that these transactions somehow unfairly benefited any allegedly interested director or related party. Rather, the Complaint alleges that the Company earned for its shareholders "enormous profits" that it should have allowed the allegedly related parties to retain. (A66; ¶133).

Plaintiff also conceded at oral argument that she has neither requested or reviewed the Board's meeting minutes or made any other books and records request with respect to any of the matters alleged in the Complaint. (B54-55, B60).

*10 ARGUMENT

I. THE TRIAL COURT CORRECTLY DISMISSED THE COMPLAINT BECAUSE PLAINTIFFS NEITHER MADE A PRE-SUIT DEMAND NOR PLED ADEQUATE REASONS FOR FAILING TO DO SO

A. Question Presented

Whether the Chancery Court correctly dismissed the Complaint for failure to adequately plead demand futility in the absence of particularized allegations sufficient to show that a majority of the Director Defendants confront a substantial likelihood of personal liability for knowingly engaging in fraudulent or illegal conduct or for consciously disregarding in bad faith their fiduciary or contractual duties to oversee allegedly improper transactions or accounting practices.

B. Scope of Review

The dismissal of a derivative suit under Rule 23.1 is reviewed de novo. **Stone**, 911 A.2d at 371; *Beam v. Stewart,* 845 A.2d 1040, 1048 (Del. 2004). The scope of the Supreme Court's review of such a decision

is plenary. *Brehm v. Eisner,* 746 A.2d 244, 253 (Del. 2000). While the Court "should draw all reasonable inferences in the plaintiffs favor," to be *reasonable,* such inferences "must logically flow from particularized facts alleged by the plaintiff. '[C]onclusory allegations are not considered as expressly pleaded facts or factual inferences.' Likewise, inferences that are not objectively reasonable cannot be drawn in the plaintiffs favor." *Beam,* 845 A.2d at 1048, *quoting, White v. Panic,* 783 A.2d 543, 549 (Del. 2001) (emphasis in original). "What the pleader must set forth are particularized factual statements that are essential to the claim" and "a prolix complaint larded with conclusory language, like the Complaint here, does not comply with these fundamental pleading mandates." *Brehm,* 746 A.2d at 254.

C. Merits of Argument

Nothing in the Complaint is sufficient to show, as it must, that the Board systematically or consciously in bad faith (a) approved of the allegedly improper transactions and accounting practices; or (b) failed to exercise reasonable oversight. Nor does the Complaint allege particularized facts sufficient to show that the Board committed any non-exculpated act, was grossly negligent or recklessly indifferent to the Company's shareholders, or undertook any actions wholly "without the bounds of reason" such that a majority of the Director ***11** Defendants confront a substantial likelihood of personal liability. Plaintiff's failure to make the requisite pre-suit demand, therefore, cannot be excused and the Chancery Court's decision should be affirmed.

1. Delaware Law Requires Plaintiff To Plead With Particularity That A Majority Of The Director Defendants Confront A Substantial Likelihood Of Personal Liability For A Non-Exculpated Claim

Delaware law requires that "a plaintiff shareholder make a demand upon the [company's] current board to pursue derivative claims owned by the [company] before a shareholder is permitted to pursue legal action on the [company's] behalf." *Jacobs v. Yang,* 2004 WL 1728521, at *2 (Del. Ch. 2004); see also Del. Ch. Ct. R. 23.1. This "demand requirement is a recognition of the fundamental precept that directors manage the business and affairs of corporations." *Aronson,* 473 A.2d at 812. It provides a company "the opportunity to address an alleged wrong without litigation, to decide whether to invest the resources of the [company] in litigation, and to control any litigation which does occur." *Spiegel v. Buntrock,* 571 A.2d 767, 773 (Del. 1990) (citations omitted). For these reasons, the requirement of a pre-suit demand is a "bedrock principle" of Delaware law. *Levine v. Smith,* 591 A.2d 194, 200 (Del. 1991), overruled on other grounds, *Brehm v. Eisner,* 746 A.2d 244 (Del. 2000).

Where, as here, a plaintiff fails to make a pre-suit demand, she must meet the "heavy burden" of pleading demand futility under Delaware law. Levine, 591 A.2d at 211. If directors are alleged to have made a conscious decision in breach of their fiduciary duties, then a court "must decide whether, under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment." *Aronson,* 473 A.2d at 814. If "the subject of the derivative suit is not a business decision of the board" but, rather, a violation of oversight duties, then a court must "determine whether or not 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." *Rales v. Blasband,* 634 A.2d. 927, 934 (Del. 1993).

In attempting to meet either of these tests, a plaintiff must "comply with stringent requirements of factual particularity that differ substantially from the permissive notice pleadings governed solely by Chancery

Rule 8(a)." ***12** Brehm, 746 A.2d at 254. And, "[s]ince a plaintiff must plead with particularity the reasons why demand should be excused, when a reason is that the directors are disabled by the risk of liability, the claim for relief against the directors must also be pled with particularity." *In re Baxter Int'l, Inc. S'holders Litig.,* 654 A.2d 1268, 1270 (Del. Ch. 1995). Moreover, where the directors are contractually or otherwise exculpated from liability for certain conduct, "then a serious threat of liability may only be found to exist if the plaintiff pleads a *non-exculpated* claim against the directors based on particularized facts." *Guttman v. Huang,* 823 A.2d 492, 501 (Del. Ch. 2003); *accord, **Stone**,* 911 A.2d at 367.

Plaintiff correctly observes, but misconstrues in application, the principle that "[d]emand is futile when a reasonable doubt exists that the board is capable of making an independent decision to assert a claim if demand were made." (OB 16, internal citation omitted). In *Aronson,* this Court recognized that the "problem with the [reasonable doubt] formulation" is that "demand futility becomes virtually automatic under such a test." 473 A.2d at 814. Rather, "bearing in mind the presumptions with which director action is cloaked," demand futility "must be approached in a more balanced way" and "the mere threat of personal liability ... is insufficient to challenge either the independence or disinterestedness of directors." *Id.* at 814-815. Accordingly, a "reasonable doubt" that a majority of directors is incapable of considering demand should only be found "in rare cases" where "a substantial likelihood of personal liability [] exists." *Id.; see also Rales,* 634 A.2d at 936; *In re Baxter,* 654 A.2d at 1269 (demand futility pleading burden is satisfied only where the potential for director liability rises to a "substantial threat"). Plaintiff has failed to meet these pleading requirements.

2. Demand Was Not Futile Because The Director Defendants Are Exculpated Against The Liability Alleged In The Complaint

MMA's Operating Agreement eliminates any threat of personal liability, including liability for alleged breaches of fiduciary duties not based on "fraudulent or illegal conduct" or a "bad faith" breach of contract. (A243-44). To excuse demand based on a substantial threat of personal liability, Plaintiff must therefore plead particularized facts showing that a majority of the Director Defendants engaged in fraudulent or illegal conduct or breached the MMA Operating Agreement in bad faith. Her Complaint does not allege any such claims.

First, Plaintiff apparently concedes that she has not pled with particularity any claim based on fraudulent conduct. (B48-49) At oral argument, ***13** she specifically confirmed that there was nothing "inherently fraudulent" about the allegedly improper asset transactions, acknowledging in response to the Chancery Court's inquiry that "no, we do not know that necessarily by them taking back the loan, it was fraudulent." *(Id).* The Complaint, in fact, does not even purport to state a cause of action for fraud, much less detail the facts necessary to support such a claim. Instead, Plaintiff makes only the conclusory allegation that the Director Defendants made "affirmative misrepresentations" and "actively condoned and facilitated a campaign of deceit." (A57, A89; ¶¶ 103, 169). Delaware law has long confirmed that such assertions do not state a claim for fraud. *See, e.g., Metro Commc'n Corp. BVI v. Advanced Mobilecomm Techs., Inc.,* 854 A.2d. 121, 144 (Del. Ch. 2004). [9]

Similarly, the Complaint makes conclusory assertions about alleged violations of securities and tax laws without pleading with particularity the specific conduct each Director Defendant engaged in that was "fraudulent or illegal." Here, as in another Chancery Court decision involving nearly identical allegations that were found insufficient to excuse demand, the Complaint "is quick to prattle off numerous alleged infractions of laws, rules and principles," but never indicates "the Board's involvement in [the Company's] financial recording and reporting systems." *Rattner v. Bidzos,* 2003 WL 22284323, at *13 (Del. Ch. 2003). Rather than allege such particulars, the Complaint only baldly asserts that the Director Defendants "directly

ratified the egregious actions complained of herein" and "active[ly] participat[ed] and acquiesc[ed] in the scheme." (A85, A78; ¶¶ 164, 160). Such conclusory allegations are not accepted as true under Delaware law and fall short of the particularity required to plead around the Operating Agreement's exculpatory and indemnity provisions.

Moreover, as this Court noted in ***Stone***, even proof that a violation of law occurred is not enough to implicate the directors and impose on them personal liability. 911 A.2d at 372 ("The lacuna in plaintiffs' argument is a failure to recognize that the directors' 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."). In ***Stone***, the fact that a violation of law had occurred was not in dispute, but that was not a sufficient basis on which to conclude or infer that the directors knowingly committed the ***14** violation or could be held liable because of it. Here, the premise for director liability is even more specious because no violations of law have occurred and none is adequately pled. [10]

Second, the Complaint does not purport to allege a "bad faith violation of the implied contractual covenant of good faith and fair dealing." Under Delaware law, the implied covenant of good faith and fair dealing functions to protect "stockholders' expectations that the company and the board will properly perform the contractual obligations" they have under the operative organizational agreements. *Gale v. Bershad,* 1998 WL 118022, at *1-2 (Del. Ch. 1998). It is a creature of contract, distinct from the fiduciary duties Plaintiff asserts here. *Blue Chip Capital Fund II Ltd. P'ship v. Tubergen,* 906 A.2d 827, 833 (Del. Ch. 2006) (dismissing fiduciary duty claims that overlap with an alleged breach of the implied covenant of good faith and fair dealing in order to preserve "the primacy of contract law over fiduciary law in matters involving essentially contractual rights and obligations"). Here, the Complaint does not allege any contractual claims at all, let alone a "bad faith" breach of an implied contractual covenant.

3. Demand Was Not Futile Because Plaintiff Fails To Allege With Particularity The Scienter Necessary To Plead a Non-Exculpated Claim

The Complaint also fails to plead a non-exculpated claim for personal liability because it does not plead with particularity "that the directors knew they ***15** were not discharging their fiduciary obligations" or engaging in "conduct that is qualitatively different from, and more culpable than, the conduct giving rise to a violation of the duty of care (i.e., gross negligence)." ***Stone***, 911 A.2d at 369; *see also, Desimone v. Barrows,* 924 A.2d 908, 935 (Del. Ch. 2007) (where directors are exculpated from liability except for claims based on "bad faith" or a knowing violation of law, plaintiff must plead particularized facts that demonstrate that a majority of the directors had a culpable state of mind with respect to the matters alleged). The Complaint does not allege any such facts.

a. The Complaint Does Not Allege With Particularity That The Board Knowingly Approved Improper Transactions Or Accounting Practices

As a threshold matter, Plaintiff does not plead this requisite scienter because she does not allege with particularity that the Board was involved in any of the Company's decisions with respect to any of the challenged transactions or accounting practices. And, even if the Board was involved in any such decisions, the Complaint does not allege any facts showing that the Board acted in bad faith with the knowledge that such transactions or practices were improper.

First, the Complaint does not adequately plead that the Board was involved in any decision at all about whether MMA charitable contributions should be used to fund debt service. Rather, the Complaint

acknowledges that MMA made its charitable contributions to separate entities that determined how to distribute and use those donations. (A32-34; ¶ 51, 53, 55). The Complaint does not even identify the "related entities" that allegedly received MMA's charity, much less any facts showing that the Board knew those entities would use the Company's donations to service debt held by MMA. And, even if some charitable contributions were, as alleged, ultimately used to service debt, there is nothing in the Complaint that would establish that the Board had any reason to believe that such use was unreasonable, irrational, or unsupported by legitimate, lawful business objectives. Thus, with respect to the alleged charitable contributions, Plaintiff does not sufficiently plead a Board decision, let alone a decision that amounts to a bad faith breach of any contractual or fiduciary duty. *See, e.g., Desimone,* 924 A.2d at 938 (declining to infer a board decision or culpable knowledge with respect to allegedly back dated stock options where the complaint did not allege any details about the board's involvement in the option granting process).

Second, Plaintiff's challenge to the allegedly "improper asset transactions" with related parties is similarly specious and insufficient to ***16** establish the requisite scienter. Plaintiff oddly asserts that the Director Defendants should be personally liable to MMA shareholders for making "enormous profits" on the Company's investments in three of its hundreds of holdings -- i.e., for successfully engaging in the very business the Company was formed to pursue. (A59-60; ¶ 110). Specifically, Plaintiff claims that these transactions were improper because the Company took deeds in lieu of foreclosure from allegedly related parties and then sold the underlying real estate assets to realize their appreciated value. (A66; ¶ 133) (alleging that the related party borrower -- and not MMA -- should have "retain[ed] the net gain for itself). The Complaint alleges that by securing those profits on behalf of MMA's shareholders, instead of ceding them to the allegedly related parties, MMA exposed its shareholders to potential tax liabilities that the Plaintiff speculates could arise as a result of the transactions. (A71; ¶¶ 145-46).

Putting aside the undisputed fact that no one (other than the Plaintiff) has ever suggested that these successful transactions ran afoul of the tax laws, the Complaint pleads no facts indicating when, how, or under what circumstances the Board considered and approved them. Nor is there anything in the Complaint to indicate that the Board believed that earning such "enormous profits" could somehow be improper. The Complaint, for example, does not plead with particularity that the influence of allegedly related parties induced a fiduciary or contractual breach to the detriment of shareholders; rather, it claims that the transactions potentially exposed MMA and its shareholders to speculative and vague tax liabilities. *(Id.)*. And there is nothing in the Complaint indicating whether or under what circumstances the Board was advised about or considered whether these profitable transactions could even potentially violate the tax laws. Under such circumstances, there is no basis on which to infer that the Board consciously acted in bad faith with respect to these transactions. [11]

Third, Plaintiff fails to allege any particularized facts showing that the Board approved, or had actual knowledge of, the Company's allegedly improper application of FAS 115. The Complaint, for example, does not allege: any facts about the work performed by MMA's Audit Committee in reviewing the ***17** Company's determination that certain assets should be considered as only temporarily impaired; any facts about who, if anyone, advised the Audit Committee about the Company's valuation of allegedly impaired assets; or any facts about the basis on which the Board allegedly approved such valuations. *See, e.g., Guttman,* 823 A.2d at 498 (dismissing complaint that was "devoid of any pleading regarding the full board's involvement in the preparation and approval of the company's [allegedly improper] financial statements").

Plaintiff errs in asserting that mere membership on an audit committee is enough to infer the requisite scienter. (OB 23). Delaware law flatly rejects such an unwarranted inferential leap. In *Rattner,* for example, the Chancery Court declined to infer that the directors had a culpable state of mind based on allegations that certain board members served on an audit committee and, therefore, should have been aware of the

facts on which plaintiff premised her interpretation of "SEC rules and regulations, and FSAB and GAAP standards." *Rattner,* 2003 WL 22284323, at *12. The complaint in *Rattner* was strikingly similar to the Complaint at issue here. As described by the Chancery Court:

> The Amended Complaint sets forth vast tracts of quoted materials from public sources, detailing wrongdoings in the form of alleged misstatements. The Amended Complaint also summarizes numerous SEC rules and regulations, and FASB and GAAP standards. However, conspicuously absent from any of the Amended Complaint's allegations are particularized facts regarding the Company's internal financial controls during the Relevant Period, notably the actions and practices of [the company's] audit committee. The Amended Complaint also is similarly wanting of any facts regarding the Board's involvement in the preparation of the financial statements and the release of financial information to the market.

Id.

In light of these pleading omissions, the Chancery Court in Rattner rejected Plaintiff's asserted inferences, holding that:

> The only information one can snare from the Amended Complaint is that there exists a body of rules regarding the accuracy of recording and ***18** reporting financial information which may have been violated.... Therefore, I am unable to conclude that a majority of the Board faces a substantial likelihood of liability for failing to oversee [the Company's] compliance with required accounting and disclosure standards.

Id. at *13.

Here, as in *Rattner* and numerous other cases, conclusory assertions that the Defendants' "knew or should have known" about the matters alleged in the Complaint are "entirely devoid of particularized allegations of fact demonstrating that the outside directors had actual or constructive notice of the [alleged] improprieties." *Guttman,* 823 A.2d at 498.

Moreover, the Complaint offers no facts contradicting the Company's belief that it was likely to receive "all amounts due" for these assets consistent with what Plaintiff concedes is an appropriate factor to consider in properly applying FAS 115. (A57; ¶ 104). Plaintiff, in fact, admits that FAS 115, by its very terms, requires a subjective evaluation about whether "it is probable that the investor will be unable to collect all amounts due." (A38; ¶¶ 65). Yet the Complaint does not allege that the Company ever failed to receive full value for any such assets. Given this omission, it is patently unreasonable to simply infer, as Plaintiff suggests, that the Board had any reason to conclude that the Company's subjective evaluation under FAS 115 was somehow improper. [12]

b. An Inference Of Board Approval, Even If Accepted As Plaintiff Suggests, Is Insufficient As A Matter Of Law To Establish Demand Futility

Plaintiff contends that the Chancery Court should have inferred that the Board "had knowledge of certain transactions because [it] had to authorize the transactions." (OB 18). Specifically, Plaintiff argues that such knowledge should be inferred because the alleged transactions were "related party transactions" that the Board was required to approve under the Company's Operating Agreement. ***19** (A30-34, A48-67; ¶¶ 47-56, 86-134; OB 2, 9, 22-23, 26, 27-28). Plaintiff's assertion misses the point. The Chancery Court did not refuse to draw what the Plaintiff claims is an "obvious" inference that the Board may have approved related party transactions pursuant to the Operating Agreement. Instead, the Chancery Court correctly applied Delaware law by declining to infer from any such approval that each member of the Board knew that the alleged transactions were improper or that the Board consciously and in bad faith failed to discharge fiduciary or contractual responsibilities with respect to them.

Delaware law on this point is clear: board approval of a transaction, even one that later proves to be improper, is an insufficient basis for inferring culpable knowledge or bad faith on the part of individual directors. *Aronson,* 473 A.2d at 814. As this Court has taught, "mere directorial approval of a transaction, absent particularized facts supporting a breach of fiduciary duty claim, or otherwise establishing the lack of independence or disinterestedness of a majority of the directors, is insufficient to excuse demand." *Aronson,* 473 A.2d at 817. Any such alleged board approval does not "automatically connote [] 'hostile interest' and 'guilty participation' by directors, or some other form of sterilizing influence upon them. Were that so, the demand requirements of our law would be meaningless, leaving the clear mandate of Chancery Rule 23.1 devoid of its purpose and substance." *Id.* at 814; *see also, Guttman,* 832 A.2d at 506 (company's allegedly improper financial statements did not create inference that "directors were conscious of the fact that they were not doing their jobs"); *Desimone,* 924 A.2d at 938-939 (board approval of backdated options did not create inference that directors knew that options were improper).

In fact, in the absence of particularized facts to the contrary, Delaware law presumes that directors "acted properly" and "'[t]he burden is on the party challenging the decision to establish facts rebutting the presumption.'" *Orman v. Cullman,* 794 A.2d 5, 20 (Del. Ch. 2002), *quoting Aronson,* 473 A.2d at 812. Because mere board approval of a transaction is legally insufficient to establish the requisite director knowledge that the alleged transactions and accounting practices were improper, the Chancery Court correctly refused to draw such an inference based on the Board's alleged approval of related party transactions. Absent facts that would show that the directors "act[ed] with scienter," they would be "protected from liability" and therefore capable of impartially considering a pre-suit demand. *Desimone,* 924 A.2d at 933.

***20 c. Plaintiffs Conclusory Assertions About The Existence Of "Red Flags" Are Insufficient To Excuse Demand**

Plaintiff also errs in contending that the Board knowingly ignored "red flags." (OB 7, 12-14). Plaintiff, for example, asserts that the Director Defendants must have known that FAS 115 was not being properly applied when the Company declined to accept what it deemed to be inadequate offers on the so-called "Distressed Portfolio Offering." (OB 27-28). Plaintiff apparently contends that the inadequate offers received in response to the offering and the Company's subsequent withdrawal of the offering should have alerted the Director Defendants that the Company's application of FAS 115 was overvaluing the assets in the portfolio. *(Id.)*.

Even if, however, the Court assumes as true that the Board approved of the portfolio offering and further assumes that the portfolio assets had been improperly valued, there is nothing in the Complaint suggesting that any individual Director Defendant was made aware of any such accounting problem. The Complaint, for example, does not indicate whether, how or by whom the Board was advised about the rejected bids. Plaintiff does not even suggest a plausible reason why the Board would have been advised of offers that MMA employees considered inadequate. Nor are there any facts suggesting that any Director, much less all of them, was told or advised that MMA's accountants were not properly applying this accounting statistic. Plaintiff effectively conceded as much during oral argument in the Chancery Court. Specifically, the court asked whether the Plaintiff had examined the Company's records relating to the valuation of the so-called non-performing assets and Plaintiff responded "we did not." (B55). The court then asked whether the Plaintiff alleged any facts showing that any Board member was advised that the results of the offering indicated an accounting problem:
THE COURT: Do you have any evidence and is it in your complaint from your confidential source or anyone else that when ... this auction failed, that ... somebody went to the audit committee or to the board or to the company's outside accountants and said "We are out of compliance with GAAP in our reporting of the valuation of these impaired assets"?

MR. HINTON: There's no -- no, we do not know... ***21** (B37).

Delaware law is clear that "red flags are only useful when they are either waved in one's face or displayed so that they are visible to the careful observer." *Rattner,* 2003 WL 22284323, at *13, *quoting, In re Citigroup,* 2003 WL 21384599, at *2 (internal quotations omitted). Thus, even if the Court were to infer that every member of the Board knew about the portfolio offering, such an inference falls far short of facts sufficient to show that every member of the Board knowingly permitted an improper valuation of those assets under FAS 115.

The Chancery Court, therefore, correctly concluded that there were no cognizable "red flags" sufficient to allow an inference that the Director Defendants knew that FAS 115 was being improperly applied or otherwise consciously and in bad faith ignored any such valuation issues. (B55-57).

The cases on which Plaintiff relies confirm this conclusion. Unlike the Complaint here, the pleadings in those cases alleged particularized facts on which the court could conclude that the directors were aware of the alleged misconduct, knew it was unlawful, and failed to do anything about it. These cases, in fact, confirm what is missing from Plaintiff's complaint: particularized factual allegations about the state of mind of the directors.

Plaintiff, for example, cites *McCall v. Scott,* 250 F.3d 997 (6th Cir. 2001). (OB 21). The particularized facts alleged in that case demonstrated that the board had been given ample notice of the alleged improprieties related to the company's billing practices, including: (a) internal audit reports, presented to the board, that detailed company activities that identified "possible violations of law;" (b) statistical evidence brought to the board's attention suggesting that company's billing practices were awry; (c) prior lawsuits challenging the company's billing practices; (d) federal investigations and raids of the companies facilities to collect evidence of the company's billing practices; and (e) a series of *New York Times* articles revealing that the company's billing practices were out of line with those of its competitors. [13] No such particularized facts are alleged here.

***22** Plaintiff also cites *In re Veeco Instruments, Inc. Sec. Litig.* (OB 18, 34), a federal court derivative action alleging that a board of directors breached its fiduciary duties by failing to oversee, monitor and manage the

internal accounting controls of the company and failing to maintain compliance with federal export control laws. 434 F. Supp. 2d 267 (S.D.N.Y. 2006). In that case, the plaintiffs alleged particularized facts showing that the board of directors received actual notice from an employee of the company that violations of federal export controls laws had occurred. Faced with this knowledge, the board took no action to improve its control environment. As a result, a second violation of law occurred seven months later. *Id.* at 278. No such particularized facts are alleged here.

Similarly, the court in *In re Abbott Labs. Deriv. S'holder Litig.,* also cited by Plaintiff (OB 21), found it reasonable to infer that the directors knew that violations of law were occurring based on particularized allegations showing that the Food & Drug Administration ("FDA") had conducted thirteen inspections of two Abbott facilities, determined that both facilities were not in compliance with FDA regulations and issued four warning letters to Abbott over a six-year period urging Abbott to comply with its regulations. 325 F.3d 795, 799-800 (7th Cir. 2001. The Abbott board took no action to comply and stated publicly that it disagreed with the FDA's findings, confirming that it was aware of the alleged conduct and acknowledging that a regulator thought it was illegal. Abbott eventually settled with the FDA after agreeing to pay $100 million fines and destroying $250 million worth of adulterated drugs. *Id.* at 781. No such particularized facts are alleged here.

Likewise, the plaintiff in *Ryan v. Gifford,* alleged that the defendant directors deliberately violated a shareholder stock option plan by approving backdated stock option grants. 918 A.2d 341 (Del. Ch. 2007). Because the Board had no discretion to determine the date of the options grants, and because the plaintiff alleged particularized facts showing that the options were dated in direct violation of the Board's obligations, the court concluded that it was reasonable to infer that the manipulation of the option dates was intentional and done in knowing in contravention of the express terms of the stock option plan. *Id.* at 354, 355 n.34. No such particularized facts are alleged here.

In marked contrast to these cases, Plaintiff here alleges no specific facts indicating that any member of the MMA Board knowingly engaged in illegal conduct or in bad faith failed to prevent such conduct to the detriment of MMA or its shareholders. This case is, instead, a replay of the insufficient claims dismissed in ***Stone****; Guttman; Rattner;* Desimone and the legion of other cases where the plaintiff failed to allege any reasons why particular defendants should ***23** have been on notice of alleged accounting improprieties, where mere board approval or audit committee membership were insufficient, and where no facts were alleged suggesting that the Board knowingly allowed or participated in a violation of law. *See e.g., In re Fannie Mae Deriv. Litig.,* 2007 WL 1577872 (D.D.C. May 31, 2007); *In re Citigroup S'holders Litig.,* 2003 WL 21384599 at *2; *David B. Shaev Profit Sharing Account,* 2006 WL 391931 at *3, *5; *Beam v. Stewart,* 833 A.2d at 975-76.

The failure of the plaintiffs in such cases is frequently compounded by a failure to make a books and records request about the matters alleged and the board's consideration of them. *See e.g., Desimone,* 924 A.2d at 951 (failure to make a books and records demand rendered plaintiff "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."); Beam, 845 A.2d at 1057 n. 52 ("plaintiff should pursue a books and records inspection in order to secure the facts necessary to support an allegation of demand futility if the factual allegations would otherwise fall short.").

Here as well, Plaintiff could have, but chose not to, confirm whether any facts exist to support her demand futility allegations by making a books and records request pursuant the Delaware LLCA. *See* 6 Del. C. § 18-305 (providing shareholder certain rights to obtain "information regarding the status of the business and

financial condition of [a] limited liability company"). Having failed to avail herself of such information, Plaintiff's pleading omissions should not be countenanced.

4. The Complaint Itself Refutes Plaintiff's Oversight Claims And Confirms That Demand Would Not Have Been Futile

Plaintiff's assertion that the Director Defendants confront personal liability for their alleged failure to adequately oversee the Company's affairs also fails because it cannot withstand the admissions in her own Complaint. As this Court has explained, a plaintiff relying on the threat of personal liability to excuse demand for a *Caremark* oversight claim must plead with particularity the following "necessary conditions predicate" for such liability:

> (a) the directors *utterly failed* to implement any reporting or information system or controls; or (b) having implemented such a system or controls, *consciously failed to monitor or oversee its* operations thus disabling themselves ***24** from being informed of risks or problems requiring their attention.

Stone, 911 A.2d at 370 (emphasis added).

Plaintiff does not, and cannot, meet this pleading burden. Rather, her Complaint confirms -- rather than refutes -- that the Board established and maintained information or reporting systems and undermines any assertion that the Director Defendants "utterly failed" to have such systems in place. The Complaint, in fact, is replete with specific factual allegations demonstrating that the Company and/or its Board established and maintained information and reporting systems and controls:
MMA has an Audit Committee whose principal duties include: "monitoring the integrity of the financial reporting processes and systems of internal controls; monitoring the Company's compliance with legal and regulatory requirements; monitoring the independence, qualifications, and performance of the Company's independent registered public accounting firm and internal audit function." (A86; ¶ 165).

MMA considers and applies the accounting directive concerning other-than-temporarily impaired assets (FAS 115) in its financial statements. (A36-38; ¶¶ 61-64).

MMA evaluated and determined that a November 2005 amendment to FAS 115 "had no material effect on [MMA's] reported financial condition or results of operations." (A56-57; ¶ 103).

MMA performed reviews of the properties collateralizing each bond in its portfolio. (A42; ¶ 68).

MMA has an Audit Committee that has reviewed with MMA's management "material weaknesses related to the financial reporting process, including the sufficiency of resources dedicated to the Company's accounting function." (A71-72; ¶ 148).

The Complaint thus falls under its own weight, confirming as it does that the Director Defendants face no prospect of being found "guilty of a sustained ***25** failure to exercise their oversight function." Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959, 971 (Del Ch. 1996).

Moreover, Plaintiff's assertion that the Company's restatement of earnings "evinc[es] Defendants' grossly inadequate monitoring and understanding of the Company's dire financial position and reporting controls" (A224) turns logic on its head. Plaintiff does not contest that the restatement process came about because the Company itself monitored internal reporting and information systems and proactively uncovered accounting errors that the Board began to address well before the Complaint in this matter was filed. The notion that such vigilance somehow "evinces grossly inadequate monitoring" should not be countenanced. If it were, then no board could ever act in response to concerns about accounting systems and controls without being sued immediately thereafter. Plaintiff's position, if adopted, would encourage boards to turn a blind eye when confronted with matters that they should, instead, be vigilant in addressing. Delaware law should not permit such an anomaly.

Equally flawed is Plaintiffs contention that the Court should infer that the Board breached its fiduciary duties because "the Company admittedly failed to require evidentiary support" in valuating the allegedly impaired assets. (OB at 30). In support of this contention, which does not appear in her Complaint, Plaintiff relies on public disclosures made by the Company on July 9, 2007 concerning its restatement process. (A318-26). The disclosure states that sometime after May 4, 2007, the Company discovered that "it did not critically assess valuations of bonds provided by third parties." *(Id.)*.

As an initial matter, the disclosures Plaintiff identifies directly contradict the allegations of her Complaint. Specifically, the disclosures explain that MMA previously had *undervalued* some of the assets in its tax-exempt portfolio whereas the Complaint alleges that MMA incorrectly *overvalued* such assets. [14] Thus, the only thing the disclosures make clear is that MMA's prior valuation of assets was too conservative - not, as Plaintiff would have it, deceptively inflated.

26** But even if the restatements and disclosures reflected the specific accounting errors alleged in the Complaint, such a fact would not, as Plaintiff suggests, support an inference that the Director Defendants failed to exercise appropriate oversight. As this Court explained in ***Stone, the fact that a company's internal controls were, in hindsight, inadequate "is not alone enough for a court to conclude that a majority of the corporation's board of directors is disqualified from considering demand." 911 A.2d at 371. Otherwise, demand automatically would be excused in every case involving a restatement of earnings.

As the Chancery Court observed, the restatement process refutes any notion that the MMA Board could not have impartially considered a pre-suit demand:

> [W]hat I see is the board of directors and its audit committee in particular engaged in what seems to be a pretty searching inquiry into the company's internal controls and its financial statements... [G]iven that, why would I assume that [] those same people, if asked to look into the things that you allege here, wouldn't look into them and couldn't do so in the exercise of their business judgment?

(B51).

In short, the Chancery Court correctly applied controlling Delaware law and properly concluded that Plaintiff failed to meet her burden to sufficiently plead demand futility based on the Director Defendants' alleged personal liability. [15]

*27 CONCLUSION

For the foregoing reasons, Plaintiff does not and cannot meet her stringent burden of pleading particularized facts sufficient to excuse pre-suit demand. The Chancery Court's decision should be affirmed.

Footnotes

1 Citations in this Answering Brief are in the following format: "A_ refers to the record set forth in Plaintiff's Appendix; "B_ refers to the record set forth in Defendants' Appendix; "OB __" refers to Plaintiff's opening brief on appeal; and "¶ ___" refers to a specific paragraph of the Complaint.

2 Plaintiff did not serve the amended Complaint on Defendant Banks until after the other Defendants had filed their motion to dismiss. After he was served, Defendant Banks filed a separate motion to dismiss and submitted a joint brief with the other Defendants in support of the motions. (A5-6; A104).

3 Plaintiff also abandons in this appeal her contention, necessarily rejected by the Chancery Court, that the Director Defendants could not impartially consider a demand because they allegedly "received their own stock options as compensation, thereby personally benefiting from improper conduct alleged herein." (A89; ¶ 169; A121-24).

4 The Operating Agreement is incorporated by reference in the Complaint. (A34,A61; ¶¶ 56, 116).

5 The corollary indemnification provisions are set out in § 8.1(b) of the Operating Agreement. (A170).

6 Plaintiff no longer contends that the Director Defendants confront personal liability for issuing allegedly "excessive" dividends. She now concedes that the dividends were not issued in breach of the Company's Operating Agreement or in violation of Delaware law and that the dividends were paid fairly to all shareholders. (B61-62). Delaware law is clear that such dividends cannot form the basis for a derivative action under Rule 23.1. *See Gabelli & Co., Inc. v. Liggett Group Inc.,* 479 A.2d 276, 280 (Del. 1984) ("the declaration and payment of dividends rests in the discretion of the...board of directors in the exercise of its business judgment."). Plaintiff also has abandoned in this appeal her specious contention that the Director Defendants confront personal liability arising from allegedly excessive performance-based compensation paid to Director Defendants Falcone and Joseph. (A143-44).

7 The sparse facts Plaintiff alleges about former director Banks (A15-16; ¶ 14) are immaterial to this appeal because he was not on the Board at the time Plaintiff should have made her pre-suit demand.

8 The Chancery Court expressed doubt about whether these allegations were sufficient to establish that even these two Director Defendants lacked independence or disinterest that would render them incapable of impartially responding to a demand. (B63). This Court need not decide that issue because none of Director Defendants -- and certainly none of the eight outside current directors (who represent a majority of the ten member board) -- confront a substantial risk of personal liability for the matters alleged in the Complaint.

9 Fraud requires a false representation; made with the knowledge or belief that it was false or with reckless indifference to the truth; an intent to induce the plaintiff to act or to refrain from acting; the plaintiff's action or inaction taken in justifiable reliance upon the representation; and damage to the plaintiff as a result of such reliance. *Id.*

10 Even in cases where plaintiffs have alleged violations of law based on substantial government investigations or other civil or criminal liabilities, Delaware courts routinely dismiss derivative claims for failure to plead demand futility because the plaintiff is confusing a "bad outcome with bad faith." ***Stone***, 911 A.2d at 372; *see also, David B. Shaev Profit Sharing Account v. Armstrong,* 2006 WL 391931, at *3, *5 (Del. Ch. 2006) (complaint dismissed despite numerous civil suits and investigations and fines by the SEC, New York State, and New York City); *Rattner,* 2003 WL 22284323, at *13 (complaint dismissed despite regulatory investigations and several securities fraud class-action lawsuits); *Beam v. Stewart,* 833 A.2d 961, 975-76 (Del. Ch. 2003) (complaint dismissed despite criminal indictment and SEC investigations); *In re Citigroup S'holders Litig.,* 2003 WL 21384599, at *2 (Del. Ch. 2003) (complaint dismissed despite company's alleged involvement in the collapse of Enron); *Guttman,* 823 A.2d at 498 (complaint dismissed despite SEC investigation into alleged misconduct).

11 It is axiomatic that taxes are commonly paid on company profits without violating any law or any fiduciary or contractual obligation. Thus, the mere fact that a profitable transaction might result in tax liabilities, without

more, cannot support an inference that a director knowingly and in bad faith approved such a transaction. To hold otherwise would strip a board of its ability to exercise its business judgment in determining whether and when to realize a gain on a company investment.

12 The Complaint itself reflects the reason for these pleading omissions. MMA, as it explained in its disclosures that are quoted in the Complaint, subsequently sold some of these very same assets for at or near their full reported value, consistent the proper application of FAS 115. (A57; ¶ 104).

13 The factual background of this case is summarized in an earlier opinion. *See McCall v. Scott,* 239 F.3d 808, 820-23 (6th Cir. 2001).

14 *Compare* (A42-43; ¶¶ 69-70) (alleging that MMA improperly applied an accounting statistic to inflate the value of certain tax exempt bonds) with (A318-26) (reporting that the audited financial statements corrected "for errors related to the Company's estimation of the fair value of the bonds" that had previously undervalued the shareholders' equity in Muni Mae's TE Bond Subsidiary by some $52.9 million).

15 To the extent that they are predicated on "bad faith" or "illegal conduct," Plaintiff's ancillary claims of gross mismanagement, unjust enrichment and waste fail for the same reasons Plaintiff's duty claims fail. To the extent that Plaintiff's ancillary claims are not based on "bad faith" or "illegal conduct" they are plainly barred by the exculpation provision in the MMA Operating Agreement. In either case, the Chancery Court correctly dismissed Plaintiff's ancillary claims.

End of Document

2016 WL 6916400 (Del.Ch.) (Trial Motion, Memorandum and Affidavit)
Chancery Court of Delaware.

OKLAHOMA FIREFIGHTERS PENSION & RETIREMENT SYSTEM, Key West Municipal Fire Figheters & Police Retirement Trust Fund, Jeffrey Drowos, Retirement System of St. Louis, and Esther Kogus, derivatively on behalf of Citigroup Inc., Plaintiffs,

v.

Michael L. CORBAT, Duncan P. Hennes, Franz B. Humer, Eugene M. McQuade, Michael E. O'Neill, Gary M. Reiner, Judith Rodin, Anthony M. Santomero, Joan Spero, Diana L. Taylor, William S. Thompson, Jr., James S. Turley, Ernesto Zedillo Ponce de Leon, Robert L. Joss, Vikram S. Pandit, Richard D. Parsons, Lawrence R. Ricciardi, Robert L. Ryan, John P. Davidson III, Bradford Hu, Brian Leach, Manuel Medina-Mora, and Kevin L. Thurm, Defendants,

and

Citigroup, Inc., Nominal Defendant.

No. 12151-VCG.
November 21, 2016.

Plaintiffs' Brief in Opposition to Defendants' Motion to Dismiss Plaintiffs' Verified Amended Supplemental Stockholder Derivative Complaint

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FIREMAN'S PUBLIC - REDACTED VERSION FILED: NOVEMBER 21, 2016

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Definitions

"Banamex Group"	Grupo Financiero Banamex, S.A., a wholly owned subsidiary of Citigroup
"Board"	Citigroup's Board of Directors
"BSA/AML"	Bank Secrecy Act/Anti-Money Laundering
"BUSA"	Banamex USA, a wholly owned subsidiary of Citigroup
"CDBO"	California Department of Business Oversight, formerly the CDFI
"CDFI"	California Department of Financial Institutions
"CFPB"	Consumer Financial Protection Bureau
"CFTC"	Commodities Futures Trading Commission
"Citigroup"	or the "Company" Citigroup Inc.
"Complaint"	Verified Amended Supplemental Stockholder Derivative Complaint, filed on August 15, 2016
"CNBV"	Comisio#n Nacional Bancaria y de Valores

"FCA"	U.K. Financial Conduct Authority
"FCPA"	Foreign Corrupt Practices Act
"FDIC"	Federal Deposition Insurance Corporation
"FRB"	Federal Reserve Board
"OCC"	U.S. Office of the Comptroller of the Currency
"OSA"	Oceanografi#a, S.A. de C.V.
"SARs"	Suspicious Activity Reports required by federal BSA/AML laws and regulations.

Citation Format

¶.___	Citation to paragraph in the Complaint
Defs.Br.__	Pages of Defendants' Brief in Support of Their Motion to Dismiss Plaintiffs' Verified Amended Supplemental Stockholder Derivative Complaint, filed on September 30, 2016

PRELIMINARY STATEMENT

This case arises because Citigroup's Board refused to perform its essential function: taking reasonable measures to operate the Company in compliance with applicable laws. Plaintiffs have sufficiently pleaded that the Board failed to remedy known control deficiencies that led to illegality and fraud.

The Complaint details [Text redacted in copy.] government actions since 2010 that identified civil and criminal violations stemming from significant internal control deficiencies across Citigroup's numerous business lines. [1] The Board's refusal to monitor the Company's legal compliance resulted in approximately *$4 billion* in civil and criminal penalties, settlements, operational losses, and restitution. The Complaint's detailed allegations of the Board's widespread and systemic oversight failures portray a Board that has effectively given up on reining in the Company's misconduct:

• BSA/AML Compliance violations--multiple regulatory actions over five years, [Text redacted in copy.] advising the Board of *continued internal control deficiencies following consent orders,* and ultimately fines of $140 million for these repeated violations of law;

• OSA fraud--after years of warnings of serious control deficiencies, Citigroup's Mexican unit, Banamex, suffered a fraud loss of more than $400 million resulting from the same deficiencies, and Mexico's bank regulator fined the bank for the internal control violations;

• FX trading--the bank pled guilty to antitrust violations and was the subject of multiple regulatory actions, each of which found substantial, long-standing internal control failures, leading to nearly $2.7 billion in fines and settlements;

• Deceptive Credit Card practices--regulators found that the Board failed to oversee Citigroup's credit card business for a period of 13 years, even though specific problems were brought to the Board's attention, resulting in regulatory actions, $70 million in penalties, and $700 million in restitution.

Serious legal compliance failures at Citigroup are not a new problem. In fact, by 2008, the Board learned that the Company's internal controls to assess subprime mortgage risk were so inadequate that the Company required the largest bailout in U.S. history--$300 billion--to avoid insolvency. Against the backdrop of such glaring red flags, the multiple oversight failures at issue in this case demonstrate that the Board has simply refused to act in good faith.

Defendants assert that a felony guilty plea, myriad regulatory actions and billions in penalties, is simply business as usual for a Delaware corporation.[2] That is wrong--"Delaware law does not charter law breakers."

Each of the arguments in Defendants' Motion to Dismiss fails.

First, Defendants argue that Plaintiffs have failed to sufficiently plead demand futility. Defendants contend that the allegations should be treated separately and in isolation. This argument was rejected by the Delaware Supreme Court in *Sanchez,* which held that demand futility allegations must be addressed in totality.

Defendants' pleading argument also fails in the face of a legion of specific allegations demonstrating that Defendants knew of red flags and yet consciously failed to take action in good faith to remedy the internal control deficiencies. These red flags include government investigations and consent orders, internal reports and presentations highlighting significant compliance concerns, and prior misconduct. The Complaint details numerous instances in which regulators specifically told the Board of substantial internal control deficiencies and laid out how those deficiencies could lead to legal violations. Yet the Board failed to make good faith efforts to fix problems and prevent legal violations.

Defendants' own documents manifest their awareness of systemic control failures and legal violations. Yet these clarion calls went unheeded as Defendants chose profits over the hard path to corporate responsibility. This is precisely the scenario for which the *Caremark* doctrine was developed.

Second, Defendants contend that Plaintiffs have failed to state a claim for breach of fiduciary duty. Because Plaintiffs have established demand futility based on a failure to adopt and oversee internal legal compliance controls, they have necessarily stated a claim against the Director Defendants. Plaintiffs have also stated a claim against the Officer Defendants, as the allegations made clear that that officers knew at least as much as--if not more than--the Director Defendants and similarly failed to act.

Third, Defendants argue that their misconduct is exculpated. This contention is misplaced as to the Officer Defendants as the exculpation provisions in the charter do not apply to them. The Director Defendants are also not entitled to exculpation on a motion to dismiss, as Plaintiffs have alleged breaches of their fiduciary duty of loyalty and lack of good faith.

As the Complaint alleges with particularity Defendants' fiduciary breaches arising from their failure to exercise oversight, their motion to dismiss should be denied in all respects. [3]

STATEMENT OF FACTS

Plaintiffs' Complaint sets forth in extraordinary detail the weaknesses of Citigroup's internal controls, the red flags that brought those issues to Defendants' attention, and the apathy with which Defendants responded. The growing gaps in the Company's compliance systems reached nearly every part of Citigroup's operations. Below, Plaintiffs highlight four specific corporate traumas that evidence Defendants' laissez-faire approach to governing and the serious consequences engendered by this bad faith approach.

A. DEFENDANTS' INACTION ENABLES BSA/AML VIOLATIONS TO FLOURISH

Citigroup's directors and officers turned a blind eye to systemic violations of BSA/AML rules and regulations at BUSA for years. Lacking oversight and guidance from the Company's leadership, BUSA repeatedly ran afoul of consent orders arising from government investigations into its BSA/AML practices. At each step, Defendants learned of increasing risk, flaws in compliance programs, and ongoing violations of compliance structures, yet failed to implement effective internal controls. Ultimately, regulators imposed almost $200 million in fines because instead of implementing an effective compliance program after a series of consent orders, BUSA had actually engaged in *new* violations.

1. Defendants On Notice Of BSA/AML Violations Since 2010 In July 2010, [Text redacted in copy.] [5] Despite this warning, and despite warnings to the Board from Citigroup's own management that [Text redacted in copy.] [7]

[Note: footnote reference missing in original document]

4. ¶143.

6. ¶284.

2. The Failure to Address The OCC's Concerns Leads To Second Regulatory Order

The bank's persistent noncompliance earned it [Text redacted in copy.]--the 2012 OCC Consent Order. [8] The OCC castigated Citibank for its “inadequate system of internal controls and ineffective independent testing.” [9] The “critical” internal control weaknesses included “the inability to assess and monitor client relationships on a bank-wide basis,” “weaknesses in the scope and documentation of the validation and optimization process,” and “inadequate customer due diligence.” [10] The OCC also noted that the “independent BSA/AML audit function failed to identify systemic deficiencies found by the OCC during the examination process.” [11]

3. The FDIC And CDFI Resort To Third Consent Order

Even after [Text redacted in copy.], Defendants did nothing to change Citigroup's practices. Regulators were again forced to take action. The FDIC/CDFI Consent Order issued on August 2, 2012, ordered BUSA's board to "increase its oversight of the affairs of the Bank" and it required an "updated written compliance program." [12] The order also required that regular, comprehensive reports be delivered to BUSA's directors, that BUSA hire an "experienced" compliance officer "suitable for the Bank's size, complexity, and risk profile," and that staffing levels be capable of "monitor[ing] day-to-day compliance with BSA." [13]

Directors learned of these consent orders and of persistent BSA/AML problems at the Company and its subsidiaries. [14] In fact, every single Internal Audit report presented to the Audit Committee indicated that [Text redacted in copy.] [15] By February 2013, [Text redacted in copy.] [16] Defendants, however, ignored these problems, leading to additional enforcement activities.

4. After Three Years Of Regulatory Efforts, The FRB Cites Citigroup For Oversight Failures

Three years after the first regulatory order, Citigroup was *still* breaking the law. Its controls remained weak and it failed to oversee its subsidiaries' activities. As a result, the FRB turned its sights on Citigroup itself. The FRB Consent Order issued on March 21, 2013, focused on *Citigroup's* responsibility for the subsidiaries' non-compliance, reflecting the FRB's determination that *"Citigroup lacked effective systems of governance and internal controls to adequately oversee the activities of the Banks."* [17] It required Citigroup to ensure compliance "on a firmwide basis," and to "implement a firmwide compliance risk management program." [18] The FRB highlighted the Board's ultimate responsibility to "take steps to ensure that each of the Banks complies with the Consent Orders issued" and to submit to the FRB "an acceptable written plan to continue ongoing enhancements to the board's oversight of Citigroup's firmwide compliance [BSA/AML] risk management program." [19]

The FRB Consent Order did not go unnoticed among Defendants: the Board learned of the order at a meeting attended by ten Defendants. [20] On March 19, 2013, the Board authorized entry of the order. [21] In the following months, the Board received numerous reports about continuing BSA/AML deficiencies. [22] Indeed, [Text redacted in copy.] [23] Despite this, Defendants put off remedying the control failures and instead focused on profits.

5. After Repeated Censures, BSA/AML Violations Continue, Leading To A Record-Setting Fine

Rather than address the growing chorus of warnings about BSA/AML deficiencies, Citigroup's Board failed for the next two years to adopt effective internal controls addressing the gaps in its compliance systems, resulting in the imposition of a record-setting fine. On July 22, 2015, the FDIC fined BUSA $140 million for BSA/AML violations. [24] The FDIC determined that BUSA:

failed to implement an effective BSA/AML Compliance Program over an extended period of time...failed to retain a qualified and knowledgeable BSA officer and sufficient staff, maintain adequate internal controls reasonably designed to detect and report illicit financial transactions and other suspicious activities, provide sufficient BSA training, and conduct effective independent testing. [25]

The CDBO was similarly exasperated, noting that rather than a decline in BSA/AML issues since the FDIC/CDFI Consent Order, regulators found "new, substantial violations of the [BSA/AML] mandates over an extended period of time." [26] It imposed a $40 million fine, the largest it had ever assessed against a bank. [27] On the same day, in apparent acknowledgement of its continued oversight failures, Citigroup announced BUSA's closure. [28]

B. BANAMEX LOSES NEARLY A HALF BILLION DOLLARS IN A SINGLE FRAUD

The Board's oversight failures extended beyond regulatory violations; they also contributed to substantial fraud-related losses. In February 2014, Citigroup announced that it lost more than $400 million from fraud in an accounts receivable financing program operated by its subsidiary, Banamex, with OSA, a supplier to Mexico's state-owned oil company Pemex. The fraud developed because Banamex failed to maintain the most basic internal controls, such as validating OSA's receivables and dividing the roles of those authorizing loans to OSA. [29]

Citigroup took a $235 million post-tax write-down as a result of the fraud and suffered $165 million in incremental credit costs. [30] This erased *19% of Banamex's* profits in a year in which Banamex accounted for *10% of all of Citigroup's core revenue.* Corbat acknowledged that "the impact to [Citigroup's] credibility is harder to calculate. Arguably, it is more damaging than the financial costs." [31]

Defendants had reason to know that Banamex's controls were deficient. They knew of numerous prior frauds at Banamex that resulted from persistent control failures. Through their knowing inaction, Defendants enabled the massive OSA fraud to occur.

1. Control Deficiencies Abound At Banamex

One of the most significant gaps in Citigroup's compliance systems involved the failure to segregate duties and institute maker/checker controls. As the OCC noted, the segregation of duties is essential to banks' control activities because it reduces opportunities to commit or conceal fraud or wrongdoing. [32]

Defendants knew that maker/checker controls were perpetually deficient within Citigroup's Mexican subsidiaries. [33] The Board was also aware that Banamex's technology and control systems were not integrated with the rest of the Company, and that this incoherence between the two systems risked control failures. [34] As the FRB found after a 2008 review, "[r]eliance on manual processes that put additional pressures on controls is of particular concern." [35] The Board was aware that the Banamex Group lagged far behind in efforts to implement a common technology system. [36] In 2010 management informed the Audit Committees that [Text redacted in copy.] By September 2013--*twelve years* after acquiring the Banamex Group--Citigroup's [Text redacted in copy.] As of early 2014, [Text redacted in copy.] [37]

2. Fraud-Related Red Flags Proliferate At Banamex

The failure to disaggregate key authorities and to implement technologies effective at reducing risk contributed to fraud at Citigroup's Mexican subsidiaries for over a decade. For example,

• Over seven years, a Citigroup Treasury Finance employee fraudulently transferred $25 million to his personal bank account. [Text redacted in copy.] [38]

• Around the same time, Banamex employees accepted approximately [Text redacted in copy.] as part of a kickback scheme. Thurm reported to the Audit Committee that [Text redacted in copy.] [39]

• In 2013, management identified [Text redacted in copy.] [40] a problem that could have been addressed with an integrated technology system.

• [Text redacted in copy.] The Audit Committee, including Defendants Spero, O'Neill, Ryan Santomero, and Turley, as well as Medina-Mora, all received a report on [Text redacted in copy.]. [41]

• In October 2014, Citigroup announced that Banamex's private security unit had engaged in a series of illegal activities for nearly fifteen years, resulting in fraud amounting to $15 million. Citigroup's failure to detect these frauds is particularly troubling because the person in charge of the security unit *was the Banamex board's own lawyer.* [42]

• [Text redacted in copy.] [43]

• Management admitted that [Text redacted in copy.] [44]

These red flags preceded the collateral-related fraud at Banamex. Although reports of these frauds reached the boardroom, illuminating common control themes such as over-reliance on manual processes, disjointed technology systems, and a lack of verification of collateral, Defendants did nothing to fill the oversight gaps at the Banamex Group businesses. Unsurprisingly, therefore, the traumas grew in size and significance, leading to the half-billion dollar fraud.

3. The OSA Fraud Causes Immense Financial Trauma

On February 28, 2014, Citigroup disclosed the massive fraud in Banamex's accounts receivable financing program. "Citi, through [Banamex], had extended approximately $585 million of short-term credit to [OSA]." [45] This credit was supposed to be based on receivables due to OSA from Pemex. Over time, Banamex lent increasingly more money, notwithstanding the well-known fact that OSA had been a troubled institution for years. [46] Instead of taking the cautious approach required to effectively vet OSA, Banamex quickly developed it into one of its largest corporate clients. [47]

To accomplish this, Banamex adjusted its lending model specifically for OSA, eliminating some of the most important control procedures. [48] For example, Banamex stopped contacting Pemex to verify the receipts that OSA submitted as collateral. [49] Although the OSA loans constituted the largest accounts receivable program at Banamex, *no verification* was performed, and [Text redacted in copy.] [50] The loans were actually based on forged documents *purporting* to be Pemex invoices. [51] Banamex's loans also routinely exceeded

the value of OSA's Pemex contracts.[52] The fraud that exploited these yawning oversight gaps was not simply perpetrated by outsiders: it was facilitated by Banamex employees.[53] Management failed to detect this massive and ongoing fraud until Mexico suspended OSA from receiving new government contracts, at which time [Text redacted in copy.][54] Citigroup ultimately acknowledged that "the elimination of some basic operating controls," including the failure to segregate duties, caused the fraud.[55]

The fraud was preventable and consequential. The failure to enforce the most basic controls, combined with the sheer size of the OSA account, allowed this single fraud to wipe out almost one-fifth of Banamex's banking profits in 2013.[56] The fraud also prompted investigations by regulators.[57] CNBV "commenced an in situ extraordinary review,"[58] resulting in one of the largest fines in its history because it determined that the fraud resulted from weaknesses in Banamex's internal controls, errors in loan procedures, and deficiencies relating to risk administration and internal audits.[59] The Mexican attorney general and the SEC commenced similar investigations.[60]

C. FOREIGN EXCHANGE RATE MANIPULATION THRIVES AT CITIGROUP

The consequences of Defendants' oversight failures were not limited to BSA/AML violations and fraud. Internal control deficiencies at Citigroup permitted FX traders to engage in an extensive scheme of fraud facilitated by disclosure of confidential client information to competitors. This fraud culminated in investigations by five domestic and foreign regulators, $2.2 billion in fines, and a criminal guilty plea.

1. The FX Misconduct

Citigroup played a large role in the $5 trillion-per-day FX market through its subsidiaries Citibank and Citicorp.[61] From at least 2007 to at least 2013, Citigroup FX Traders manipulated FX benchmark rates in collusion with traders at other firms and shared confidential client information with competitors to boost profits.[62] Not only was this fraud widespread and consequential, it persisted for at least six years.

2. Regulators Cite Citigroup Subsidiaries For Control Weaknesses

The FX manipulation scheme--which thrived in the oversight vacuum--caused significant harm to the Company. On May 20, 2015, Citicorp pleaded guilty to violating federal antitrust laws.[63] According to the plea agreement, Citicorp had engaged in a "combination and conspiracy to fix, stabilize, maintain, increase or decrease the price of, and rig bids and offers for, the euro/U.S. dollar ('EUR/USD') currency pair...."[64] Citicorp paid a *$925 million* criminal fine--the highest criminal fine imposed on any bank involved in FX manipulation--and was placed on probation for three years.[65]

The guilty plea was just the latest of the regulatory actions against Citigroup and its subsidiaries in connection with the FX fraud. On November 11, 2014, the CFTC, OCC, and FCA sanctioned Citibank, finding that failures of internal controls enabled the FX fraud.

For example, the CFTC determined that Citibank knew of related attempts by banks "to manipulate [LIBOR] and other interest rate benchmarks"; yet, the FX manipulation proceeded without detection due to "internal control and supervisory failures."[66] The CFTC also determined that Citibank "failed to

adequately supervise its FX traders by, among other shortcomings, failing to have adequate controls and monitoring over the use of electronic chat rooms." [67] For these control failures, the CFTC imposed a $310 million fine. [68]

Likewise, the OCC identified "deficiencies and unsafe or unsound practices related to the Bank's wholesale foreign exchange business," ordering Citibank to submit an oversight plan that "shall provide for Board oversight of the Bank's development and implementation of internal processes and appropriately manage material risks," and imposing a $350 million fine. [69]

In its order, the FCA concluded that from 2008 to 2013, Citibank "fail[ed] to take reasonable care to organize and control its affairs responsibly and effectively with adequate risk management systems." [70] Like the CFTC, the FCA observed that Citibank was on notice of oversight failures at other firms in connection with other rate-setting misconduct, which had been identified in well-publicized Final Notices. The FX misconduct occurred "despite the fact that risks around confidentiality were highlighted when in August 2011 Citi became aware that a trader in its FX business...had inappropriately shared confidential client information in a chat room with a trader at another room." [71] The FCA noted that despite these red flags, Citibank failed to implement adequate controls or to "address the root causes that gave rise" to the FX manipulation; consequently, the FCA imposed a $358 million penalty. [72]

On May 20, 2015, the FRB issued a Consent Order, noting that "[a]s a result of deficient policies and procedures...Citigroup engaged in unsafe and unsound banking practices." [73] These defective procedures prevented Citigroup "from detecting and addressing unsafe and unsound conduct" by FX Traders and sales personnel. [74] The FRB fined Citigroup $342 million and ordered it to engage in a range of internal controls and compliance reviews. [75]

The persistence and the widespread consequences of the misconduct induced regulators to issue findings concerning significant control failures, to impose nearly $2.3 billion in fines, and to insist on a criminal guilty plea. [76] In addition, the Company has agreed to pay $394 million to settle private antitrust litigation. [77]

D. CITIGROUP DECEIVES MILLIONS OF CONSUMERS

From at least 2000 to 2013, Citigroup subsidiaries deceived consumers into acquiring or retaining add-on products (i) relating to services that they did not receive, (ii) for which they did not give their informed and affirmative enrollment consent, (iii) that they did not know they could refuse, and/or (iv) that were not in their financial interest. These dishonest practices harmed 8.8 million consumers. [78]

1. Deception Permeates Citigroup's Credit Business

Three of Citigroup's wholly owned subsidiaries were involved in unlawful credit practices: (i) Citibank; (ii) CCSI, which serviced Citibank-owned credit accounts; and (iii) DSNB, which issues credit cards for private account labels, such as Macy's. [79] These Citigroup Card Servicers peddled a variety of products as optional additions to the cards they issued, including identity monitoring, debt protection, and identity theft reimbursement services. [80] In doing so, however, they engaged in a variety of deceptive practices, affecting millions of accounts and resulting in roughly $479 million in damages to consumers. [81] These practices

persisted despite the Board repeatedly receiving reports from 2009 forward [Text redacted in copy.] and a 2011 lawsuit by the West Virginia Attorney General detailing Citigroup's illegal practices. [82]

2. Regulators Again Admonish Citigroup Subsidiaries For Fraud And Deception

In a July 20, 2015 consent order, the CFPB concluded that for thirteen years, the Citigroup Card Servicers consistently violated federal laws with respect to credit services. [83] The CFPB Credit Card Consent Order required them to pay a $35 million penalty [84] and $700 million in restitution. [85] The OCC issued its own order against Citibank and DSNB, resulting from "deficiencies in the bank's practices," and levying a $35 million civil penalty. [86] Regulators determined that the Citigroup Card Servicers had failed to enact adequate controls to ensure that their add-on credit businesses complied with consumer protection laws. [87]

With respect to the FX manipulation and credit card misconduct, both the OCC and the CFPB found the Board responsible. As to the FX collusion, the OCC stated that "the Board has the ultimate responsibility for proper and sound management of [Citibank]." [88] It made a parallel finding with regard to the Company's credit-related misconduct, stating, "the Board has the ultimate responsibility for proper and sound management of [Citibank and DSNB]." [89] Finally, the CFPB stated that it is the Board's "ultimate responsibility" to ensure "proper and sound management of [Citibank, DSNB, and CCSI] and for ensuring that [Citibank, DSNB, and CCSI] compl[y] with Federal consumer financial laws and this Consent Order." [90]

ARGUMENT

I. THE DEMAND FUTILITY STANDARD

Plaintiffs have alleged that demand on the Board would be futile because Defendants failed to act despite a duty to do so. The relevant test for evaluating the sufficiency of the demand futility allegations is the *Rales v. Blasband* test. [91] The *Rales* test "asks 'whether or not the particularized factual allegations...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.' " [92] A director cannot consider a litigation demand "if the director is interested in the wrongdoing, not independent, or would face 'a substantial likelihood' of liability if suit were filed." [93]

Defendants' own authority confirms that "Plaintiffs must show that a majority--or in a case where [as here] there are an even number of directors, exactly half--of the board was incapable of considering demand." [94] When Plaintiffs filed their initial complaint on March 30, 2016, Citigroup's Board consisted of sixteen directors, including thirteen defendants, Corbat, O'Neill, Rodin, Santomero, Thompson, Taylor, Zedillo, Spero, Humer, Turley, Reiner, Hennes, and McQuade. [95] Accordingly, Plaintiffs need only raise a reasonable doubt that *eight* of the sixteen directors could impartially consider a demand.

To show demand futility under *Rales* because a director faces " 'a substantial risk of liability,' a plaintiff does not have to demonstrate a reasonable probability of success on the claim." [96] Instead, a plaintiff need only "make a threshold showing, through the allegation of particularized facts, that [the plaintiff's] claims have some merit." [97] While a plaintiff must plead facts, she " 'need not plead evidence.' " [98]

Directors face a "substantial risk of liability" with respect to a *Caremark* claim if they "[have] fail[ed] to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities." [99] A plaintiff may make this showing by pleading that "the board consciously failed to act after learning about evidence of illegality." [100] A plaintiff may establish a sufficient connection between the trauma and the board by pleading that the directors knew or should have known of the misconduct and "yet acted in bad faith by consciously disregarding [their] duty to address that misconduct." [101]

II. DEMAND IS EXCUSED AS TO COUNT I (*CAREMARK* CLAIM) [102]

A. DEMAND FUTILITY ALLEGATIONS MUST BE VIEWED HOLISTICALLY

Faced with numerous particularized allegations demonstrating bad faith, Defendants resort to a "divide and conquer" approach by isolating and selectively attacking Plaintiffs' allegations piecemeal, as if each well-pleaded allegation exists alone in a vacuum. [103]

First, demand futility allegations must be assessed holistically, not in isolation. Recently, our Supreme Court in *Sanchez* overruled a dismissal of derivative claims for failure to plead demand futility adequately. [104] Chief Justice Strine found that this Court's demand futility analysis "seemed to consider the facts plaintiffs pled about [the director]'s personal relationship with [the company] and the facts they pled regarding his business relationships as entirely separate issues." The Court held that the Chancery Court must consider all demand futility allegations pled by plaintiffs *"in their totality and not in isolation from each other, and draw all reasonable inferences from the totality of those facts in favor of the plaintiffs."* [105] As *Sanchez* makes clear, Defendants invitation to view the well-pleaded allegations in isolation should be declined. [106]

Second, Defendants "divide and conquer" approach is flawed because it requires this Court to apply rigid rules when assessing demand futility. Once again, Defendants misconstrue well-established Delaware law. Demand futility is assessed on a case-by-case basis, paying particular attention to avoid application of such rigid rules. [107]

B. THE COMPLAINT RAISES A REASONABLE DOUBT AS TO WHETHER THE BOARD COULD OBJECTIVELY ASSESS A DEMAND

As discussed below, viewed appropriately, Plaintiffs' well-pleaded allegations establish a reasonable doubt that a majority of the Board was capable of objectively assessing a demand.

1. Defendants Misconstrue Their Duties To Monitor Fraudulent Or Illegal Conduct

Defendants' demand futility arguments mischaracterize the Board's abdication of their oversight duties as a business decision rather than a known failure to comply with the law. [108] Defendants paint the Board's widespread failure of oversight as the result of a series of unwise business judgments. [109] This case, however, is not about business risks. It is about the Board's sustained and systemic failure to ensure legal compliance.

(a) Delaware Law Requires Conscientious Attention to Compliance Failures, Not Complacency

Delaware directors have a duty to take affirmative steps to safeguard against fraudulent and illegal conduct. [110] It is incumbent upon the Board to adopt and implement reasonable controls to remain informed about the business and its risks, to monitor and oversee the business, and to take appropriate action to respond to internal control weaknesses and misconduct. [111]

In two *Caremark* cases *Pyott* and *Rosenbloom*--plaintiffs alleged that Allergan Inc.'s board failed to prevent continuing violations of the ban on off-label marketing. In *Pyott,* plaintiffs alleged that the board should have known of the illegal conduct because it: (1) approved an expansion of marketing efforts; (2) routinely monitored expansive sales growth that necessarily included off-label marketing; and (3) received a warning from the FDA that a doctor sponsored by Allergan had engaged in off-label promotion. [112] In finding demand futile, the Court emphasized that " 'Delaware law does not charter law breakers.' " [113] The Court took care to distinguish cases involving merely "wrong" business decisions, noting that those cases are "fundamentally different from imposing on directors a duty to monitor fraud and illegal activity." [114] Importantly, the Court refused to decide whether the board took "appropriate remedial action" in the face of red flags, stating that such a determination was "a factual issue that reasonably could be disputed at [the pleading stage]." [115]

The Ninth Circuit's decision in *Rosenbloom* built on the Court's decision in *Pyott.* There, plaintiffs alleged that the Allergan board "either adopted plans premised on illegal conduct or made a conscious decision not to take action even when faced with 'red flags' of wrongdoing." [116] The complaint alleged Board knowledge of the wrongful conduct because: (i) Botox was an important Allergan product that the board monitored closely; (ii) the board received data linking revenues to illegal activity; (iii) the FDA had repeatedly sent warning regarding misleading promotional activities; and (iv) the violations were "unquestionably of significant magnitude and duration." [117] Taking the allegations together, the Ninth Circuit concluded that the complaint created a "reasonable inference of inaction," excusing demand. [118]

Westmoreland is also instructive. [119] The plaintiff alleged that Baxter International, Inc. directors breached their fiduciary duties by consciously disregarding their responsibility to ensure compliance with a consent decree. [120] The Seventh Circuit found demand futility based on allegations that the illegal conduct went on for several years even after the consent decree. [121] Two years after the consent decree, the company "dramatically cut" spending on remedial efforts, and the directors decided to halt those efforts despite having received repeated FDA warnings that Baxter's remedial efforts were insufficient. [122] The plaintiffs alleged that the repeated warnings were passed to the board and that the directors were "regularly apprised of" ongoing dialogue with the FDA concerning proposed remediation plans. [123]

This Court finds demand futile in *Caremark* cases in which directors repeatedly fail to ensure their companies are in compliance with the law. In *Massey,* management "fostered a business strategy expressly designed to put coal production and higher profits over compliance with the law" and caused the company to "take an openly aggressive attitude with" regulators. [124] Plaintiffs alleged that the directors "did not make a good faith effort to ensure that Massey complied with its legal obligations" and did not "respond to numerous red and yellow flags by aggressively correcting the management culture at Massey that allegedly put profits ahead of safety." [125] "[I]nstead of using their supervisory authority over management to make sure that Massey genuinely changed its culture and made mine safety a genuine priority, the independent directors are alleged to have done nothing of actual substance to change the direction of the company's real policy." [126] Reviewing these allegations, then-Vice Chancellor Strine found that "there seems little doubt that a faithful

application of the plaintiff-friendly pleading standard would preclude dismissal...at the pleading stage." [127] As the Court explained:

when a company has a 'record' as a recidivist, its directors and officers cannot take comfort in the appearance of compliance... at the pleading stage, when the plaintiffs are able to plead particularized facts creating an inference that the Board and management were aware of a *troubling continuing pattern of non-compliance* in fact and of a managerial attitude suggestive of a desire to fight with and hide evidence from the company's regulators.

Id. at *21(emphasis added).

The conduct of the Citigroup Board is parallel in many respects to each of the cases discussed above.

(b) Defendants' Bad Faith, Knowing Failure to Act Excuses Demand

Defendants contend that the Board's only duty was to do something, regardless of whether it acted in good faith. [128] Defendants' cases for this proposition are distinguishable because they did not involve particularized allegations demonstrating that directors had reason to know the company's internal controls were inadequate in the first place, let alone that they had not been remediated, i.e., red flags of the type Plaintiffs have alleged here. [129]

Many of Defendants' cases did not involve allegations that directors received any reports about improper conduct occurring at the company; plaintiffs in those cases, unlike the Plaintiffs here, tried to rely solely on an "inference that this information reached a majority of the Board." [130]

The *Westmoreland* and *Massey* courts rejected arguments that so long as directors *do* something, they can avoid liability under *Caremark.* For example, in *Westmoreland,* plaintiff alleged that remedial efforts were " 'minimal' and 'deeply flawed.' " In response, defendants argued that this meant at most that the directors "made poor decisions," but provided "no basis to believe that [the directors] were acting in bad faith." [131] Disagreeing, the court held that the complaint sufficiently alleged that the directors' failed to promptly and adequately remedy the known issues and that demand was futile. [132] Similarly, in *Massey,* the board argued that it had acted in good faith because it "was involved in considering safety issues," "had taken steps to improve the company's safety record," and the company was "middling" as far as its rate of violations. [133] Despite defendants citing "a lot of motion by the independent directors, some of which resulted from a [] court-ordered settlement," the court found the allegations "creat[ed] a plausible inference that the [] directors [] did just that--go through the motions--rather than make good faith efforts to ensure that Massey cleaned up its act." [134]

This Court should likewise reject Defendants' attempts to manufacture the appearance of good faith remediation efforts, particularly at the pleading stage, when the facts overwhelmingly reflect a Board that was often doing nothing or, at best, simply going through the motions.

The ultimate question of whether the Board acted in good faith is one of fact that cannot be decided against Plaintiffs at the pleading stage in light of the Complaint's detailed allegations. [135] Rather, the only question is whether Plaintiffs raise a reasonable doubt of good faith. [136] They most certainly do.

2. The Complaint's Allegations Raise Reasonable Doubt That Board Acted in Good Faith

Citigroup's Board has a prolonged history of oversight failures. [137] Starting in 2007 and continuing until November 2008, the Board failed to respond to repeated warnings that Citigroup's exposure to the subprime housing market could lead to insolvency. [138] By November 2008, Citigroup required bailouts and loans of $300 billion in order to fight off insolvency. [139] Given the massive fallout from the financial crisis, the Board knew that it needed to improve controls.

Against this backdrop, the Board and senior executives gave repeated reassurance that the Company would take significant steps to improve its internal controls. [140] Instead, in business line after business line, Defendants permitted Citigroup and its subsidiaries systematically to commit fraud, enable money-laundering, collude to fix global benchmark rates, employ deceit to peddle credit products, squander customers' trust and violate law. This wrongdoing occurred because Defendants--who were aware of internal weaknesses throughout the enterprise--consciously failed to take appropriate action.

Contrary to Defendants' assertions, the Company's weak controls and the Board's failure to remedy them is not a supposition; it is an indisputable fact. Citigroup and its subsidiaries were targeted in [Text redacted in copy.] regulatory and criminal actions stemming from the complained-of internal control deficiencies. The Board's abdication of its fiduciary duties resulted in approximately *$4 billion* in penalties and related losses. These control failures were significant, on-going, and well known. That the Board left controls weak while these traumas plagued the Company raises a reasonable inference that the Board was not acting in good faith.

Defendants argue that the Complaint's allegations "are insufficient to excuse demand because...they improperly focus on outcomes, not efforts." [141] But Defendants rely on inapposite cases that involved isolated incidents of employee misconduct, not the type of endemic mismanagement or fraud that Plaintiffs have alleged here. [142]

Defendants routinely ignored serious and credible "red flags." The Company was battered with a stream of regulatory actions illustrating the Board's failures:
1. *BSA/AML Compliance:* The OCC, FDIC, FRB, and CDBO all similarly concluded, in the words of the OCC Consent Order, that Citigroup and its subsidiaries suffered from an "inadequate system of internal controls and ineffective independent testing." The consent orders required the Board to ensure BSA/AML compliance. In 2015, three years after the first FDIC consent order, the FDIC and CDBO determined that Citigroup's failure to remedy *known* BSA/AML compliance violations merited a $140 million fine. According to the CDBO, the fine arose from "substantial violations" of BSA/AML mandates *"over an extended period of time."*

2. *OSA Fraud:* CNBV imposed one of its largest fines ever because it determined that the OSA fraud resulted from weaknesses in Banamex's internal controls, errors in its loan procedures, and deficiencies relating to risk administration and internal audits. Citigroup later disclosed that CNBV "has initiated a formal process to impose additional fines on Banamex with respect to the manner in which OSA's debt was recorded at Banamex."

3. *FX Trading:* The FRB, OCC, CFTC, and FCA were unanimous in finding that Citigroup lacked adequate firm-wide governance, risk management, compliance and audit policies, enabling FX manipulation to take place over a six-year period. Citigroup and its subsidiaries paid nearly *$2.3 billion* in penalties as a result of

the rampant lack of internal controls behind the FX misconduct, including a *$310 million* fine assessed by the CFTC, a *$350 million* OCC fine, a *$358 million* FCA fine, a *$342 million* FRB fine, and a *$925 million* criminal fine.

4. *Deceptive Credit Card Practices:* The CFPB and OCC found that the Board failed to adequately oversee the conduct of Citigroup's credit-card subsidiaries for a period of 13 years. Each of the OCC and the CFPB imposed a $35 million penalty, totaling $70 million in civil penalties, and ordered the bank to pay $700 million in restitution to customers.

Thus, viewed holistically, the Complaint pleads particularized facts that at a minimum raise an inference of oversight failures at the board level. In each of these instances, the Board pursued profits at the expense of compliance. Despite repeated regulatory admonitions, the Board betrayed its duty to remedy weaknesses in Citigroup's internal controls.

Defendants contend that "[a] regulatory investigation is not a 'red flag,' "[143] but their cases are distinguishable because those investigations did not implicate directors or impose affirmative obligations on the board after finding it responsible for deficient internal controls.[144] Defendants rely heavily on *Johnson & Johnson,* but that case simply stands for the unremarkable proposition that "Director Defendants cannot face a substantial likelihood of liability for unknown conduct that *may* be discovered" in the course of an investigation.[145]

Defendants' other "red flag" cases are similarly distinguishable because they did not involve allegations that the directors learned of improper or fraudulent conduct occurring internally at the company; they involved external red flags and issues that could not be attributed solely to the company's internal control deficiencies.[146] The *Citigroup* Court distinguished that situation from the one present here, i.e., where the Board has failed to prevent fraudulent conduct, explaining:

There 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. While it may be tempting to say that directors have the same duties to monitor and oversee business risk, imposing *Caremark-type* duties on directors to monitor business risk is *fundamentally different.*[147]

Goldman Sachs is distinguishable on the same grounds; the alleged red flags there also concerned "business risk" and there was nothing to suggest "that the Director Defendants acted in bad faith or otherwise consciously disregarded their *oversight* responsibilities in regards to Goldman's business risk."[148]

Further, Defendants' cases did not involve particularized allegations regarding reports directors received--like those Plaintiffs allege here--that would allow them to intervene and remedy the compliance gaps.[149] The plaintiffs in many of those cases could not allege such particularized facts because they did not make inspection demands prior to filing suit.[150]

Here, Plaintiffs have alleged plenty of particularized facts derived from Section 220 documents. The Board's continuing and deliberate disregard for their duties to operate Citigroup in a lawful manner and to promptly

and sufficiently remedy the Company's internal compliance controls is precisely the type of *"sustained [and] systematic failure of the board to exercise oversight"* that gives rise to liability under *Caremark.* [151]

This case is also distinguishable from *Capital One,* in which the plaintiff alleged that Capital One's directors consciously failed to act after red flags concerning BSA/AML controls. Plaintiff there solely relied on internal audit reports--in particular, five such reports--to show that the board had knowledge of an escalating trend in AML compliance risk. [152] The Court dismissed the compliant because "the allegations of the Complaint plead at most...yellow flags of caution concerning the Company's escalating AML compliance risk that was occurring in tandem with heightened regulatory scrutiny of AML compliance in the financial services industry." [153] Importantly, none of the internal reports "state[d] that the Company's BSA/AML controls and procedures actually had been found to violate statutory requirements at any time and that anyone within Capital One had engaged in fraudulent or criminal conduct." [154]

Unlike *Capital One,* the Complaint here cites to three consent orders to show that the Board had knowledge of BSA/AML violations and control deficiencies. After these red flags, the Board *then* received over [Text redacted in copy.] reports evidencing that management continuously failed to comply with those same consent orders. Thus, unlike in *Capital One,* the Consent Orders are sufficient red flags to put the Board on notice that "the Company's BSA/AML controls and procedures *actually* had been found to violate statutory requirements," and the Board's subsequent failure to respond in good faith to numerous internal audit reports stating the same is enough to establish directors' liability.

C. EVEN IF VIEWED TOPICALLY, THE COMPLAINT RAISES A REASONABLE DOUBT AS TO WHETHER THE BOARD IS CAPABLE OF ASSESSING A DEMAND

Whether viewed as a global failure or analyzed business line-by-business line, the Complaint pleads particularized facts with respect to each corporate trauma, all of which show that the Director Defendants face a substantial likelihood of liability for failing to do anything of actual substance to remedy the Company's lax oversight controls.

1. BSA/AML Compliance

Defendants were repeatedly informed of significant BSA/AML violations following *four orders* issued over *three years* from 2010-2013. Moreover, the FRB Consent Order imposed an affirmative obligation on the Board to "take steps to ensure that each of the Banks complies with the Consent Orders issued." From 2013 to 2015, despite existing regulatory orders, the Board failed to act in the face of [Text redacted in copy.] [155] Following the Company's failure to comply with the consent orders, it was fined $140 million.

Defendants contend that "[i]t makes no difference that the Complaint here alleges that the Director Defendants allegedly were made aware of some of the consent orders[,]" because the allegations in ***Stone*** were purportedly "based on consent orders and fines similar to those at issue here." [156] Defendants mischaracterize ***Stone***. ***Stone*** was *not* a case in which red flags were brought to the board's attention-in fact, those plaintiffs admitted there were no red flags. [157] Instead, the question there was whether the company lacked any monitoring system that could bring problems to the directors' attention. [158] The Court refused to hold directors personally liable for the failure to file timely SARs, after a government investigation found *one* employee suspected of involvement in a possibly illegal scheme. [159] The Court explained that directors' liability cannot be based on second-guessing the reasonableness of controls "after the occurrence

of *employee conduct...that* results in *unintended* adverse outcome." [160] Here, Plaintiffs do not argue there was absolutely no monitoring system, but that when multiple red flags were brought to Defendants' attention regarding control deficiencies, Defendants acted in bad faith by failing to take any substantive action.

Here, the FDIC's findings show just how delinquent the Company was in remedying known violations of law. The FDIC found that Banamex "failed to retain a qualified and knowledgeable BSA officer and sufficient staff, maintain adequate internal controls reasonably designed to detect and report illicit financial transactions and other suspicious activities, provide sufficient BSA training and conduct effective independent testing." [161] Given years to remedy basic control deficiencies, the Board's failure to respond "was all but certain to prompt the [FDIC] to take action under the Consent Decree." [162]

2. Detection and Prevention of the OSA Fraud

Since acquiring Banamex in 2001, Citigroup was informed of repeated instances of fraud taking place at Banamex. Specifically, for a period of at least *twelve years,* the Board knew that Banamex's controls for detecting and preventing fraud were deficient, as evidenced by the following:

> • The Board knew that Mexico businesses operated within a culture that largely viewed informal compliance (such as trust and prestige) as sufficient. [163]

• The Board knew that Banamex had failed to align its technology systems with the rest of Citigroup for a period of twelve years, [Text redacted in copy.] [164]

• The Board was informed of numerous instances of fraud including an employee stealing $25 million, [Text redacted in copy.] Followin each of these frauds, the Board was told that [Text redacted in copy.] [165]

• The Board was informed b September 2013 that [Text redacted in copy.] --deficiencies that would knowingly continue unabated for nearly a year. [166]

Despite these red flags, the Board failed to take good faith action to implement controls to detect and prevent fraud. As a result, Banamex's known compliance deficiencies directly resulted in a $400 million fraud by OSA, one of Banamex's largest corporate clients.

Defendants shrug off these red flags because they represent wrongs "perpetrated by unrelated parties and relate to wholly different matters." [167] But these arguments miss the mark. As Defendants' citations make clear, failure to address in good faith known *"inadequacies in internal control mechanisms"* is sufficient to excuse demand. [168] The Board knew that the Company suffered from inadequate controls to detect and prevent fraud. Indeed, it was told that [Text redacted in copy.] [169] This knowledge of existing weaknesses in maker/checker controls and segregation of duties is the common thread between the OSA fraud and the other frauds cited in the Complaint.

Moreover, Defendants' argument that the Board's after-the-fact reaction to each transaction is sufficient to establish good faith again misses the mark. Whatever the Board may have done, its failure to address

the core issue of defective controls demonstrates that Defendants breached their duties.[170] In all events, Defendants' argument is misplaced because the Board was told all along about the lack of effective internal controls to prevent and detect fraud.

3. Misconduct in FX Trading

The Complaint's allegations establish, and numerous regulatory orders and a criminal guilty plea have confirmed, that the Board failed to implement adequate firm-wide controls to ensure that Citigroup's FX trading activities complied with the law.[171] Indeed, each regulator found that Citigroup lacked effective internal controls with respect to its FX trading activities. For example, the FRB found a lack of "adequate firm-wide governance, risk management, compliance and audit policies."[172] Similarly, the OCC noted "deficiencies in internal controls."[173] The CFTC concluded that the FX misconduct was enabled by "internal control and supervisory failures" including control failures relating to the use of electronic chat rooms.[174] Likewise, the FCA pointed to insufficient oversight and lack of training and guidance.[175]

Significantly, the Board turned a blind eye to warning signs indicating that the FX trading practices were plagued with illicit conduct. Specifically:

> • In August 2011, Citibank learned that an FX trader had inappropriately shared confidential client information in a chatroom with a competitor. Nevertheless the Board did not institute effective monitoring of chat rooms. [Text redacted in copy.][176]

• The FX misconduct was allowed to occur in the midst of the LIBOR, SIBOR, Euroyen TIBOR, and ISDAFIX scandals.[177] Regulators such as the FCA and the CFTC recognize that the rate-fixing scandals put Citibank on notice of the need for increased vigilance with respect to benchmark rate manipulation.[178]

Citigroup's argument that directors were unaware of the rate-fixing scandals ignores the regulators' finding that Citibank was on notice, and poses a question of fact not appropriately considered on a motion to dismiss. Defendants' claim that they had no responsibility for FX oversight (*i.e.,* that this was management's role alone) is similarly bogus.[179] Defendants' only support for this claim is the FCA's observation that Citibank relied on its front office to help identify and manage risks in the FX business. However, whatever role management played does not absolve the Board of its oversight responsibilities.[180] The Board had reason to know of weaknesses in controls concerning client confidentiality, use of electronic chatrooms, and benchmark rate manipulation, and yet shirked its compliance duties for years, raising a reasonable doubt that the Board is capable of assessing a demand.

4. Deceptive Credit Card Practices

For thirteen years, the Board permitted Citigroup's subsidiaries to engage in a widespread scheme to deceive customers into purchasing add-on products that the customers did not receive, understand, or know they could refuse. The pervasiveness of the deceptive credit card practices--taking place at three separate subsidiaries for more than a decade and affecting approximately 8.8 million consumers--strongly

suggests that these practices were engrained in, and an important aspect of, Citigroup's credit card business model. [181] However, the Board knowingly sat idle in the face of red flags regarding these illegal practices:

• In 2011 the Board was informed that [Text redacted in copy.] [182]

• Also in 2011, the West Virginia Attorney General targeted Citigroup for unfair and deceptive tactics in the sale of credit card protection programs. [183] The action raised claims *nearly identical* to those raised by regulators. [184]

• Following repeated admonishments by government officials, throughout 2012, the Board was repeatedly informed b the Company's own internal auditor of [Text redacted in copy.] [185]

• In 2013, Citigroup was informed of [Text redacted in copy.] after nearly 400,000 complaints. Citigroup ultimately paid $732 million in restitution. [186]

• Also in 2013, the Board received reports that [Text redacted in copy.] [Text redacted in copy.] [187]

Defendants contend that "references in the consent orders to the 'Board' and the 'Company' concern Citibank, not Citigroup, and have no bearing on the Director Defendants' discharge of their duties here." [188] This argument is baseless.

First, Citigroup is a holding company that "operates through a network of subsidiaries" with no business operations at the parent level. [189] Given this structure, misconduct necessarily takes place at the subsidiary level. Defendants cite no authority--because there is none--for the proposition that a holding company's board is not responsible for overseeing the business operations at the subsidiary level. Such a policy would invite corporations to set up holding companies and completely shield themselves and their directors from responsibility for ensuring legal compliance. That is not sound policy nor is it the law. [190]

Second, the Complaint alleges that ten of the Director Defendants simultaneously served on the board and/or as senior executives of Citibank. [191] Given the substantial overlap between the boards of directors, it is reasonable to infer the ten Director Defendants were privy to the red flags at the subsidiary level.

Third, the Board received reports regarding activities at the subsidiaries. [192] Although the Board never did anything about the reports, the fact it received them is a tacit admission that the directors knew their oversight and monitoring duties extended to the Company's subsidiaries.

5. Defendants' Claims Of Group Pleading Are Not Well Founded

Defendants suggest that Plaintiffs have "resort[ed] to impermissible group pleading." [193] Given the very specific allegations made in the Complaint, Defendants' argument is not only wrong, it is comical. The Complaint is chock full of details about which Defendants learned of particular red flags and how they did so. Page after page of the Complaint cites reports passed along to each of the Defendants. This includes *over a hundred paragraphs* [194] that lay out with respect to each of the Defendants certain instances in which they received notice of control failures. This is the far cry from the cases cited by Defendants. [195] While the Complaint occasionally references categories of Defendants, such as "Former Director Defendants,"

rather than naming them individually, this practice of "us[ing] categories of officers and directors merely as substitutes for listing names" is permissible. [196]

As to how Defendants responded (or, more to the point, did *not* respond) to the repeated red flags, Plaintiffs pled that in the face of systemic oversight failures, Defendants violated their duty to take appropriate action. [197] As the defendants attempted to do in *Massey,* Defendants here "point to a lot of motion" by the directors. [198] However, the *Massey* Court discounted what actions the defendants did take, noting that based on the plaintiffs' allegations, it was clear that the directors were just "go[ing] through the motions--rather than mak[ing] good faith efforts to ensure that Massey cleaned up its act." [199] The *Massey* Court noted that in the wake of criminal charges, Massey "continued to experience a troubling pattern of safety violations" and in the face of those violations, the directors did "nothing of actual substance to change the direction of the company's real policy." [200] That is essentially what occurred here: Plaintiffs have alleged that Defendants *knew* about the corporate traumas building within the Company. In response to regulatory and criminal violations, Defendants may have "go[ne] through the motions," but it is reasonable to infer that they did not make "good faith efforts" to ensure Citigroup cleaned up its act, as evidenced by (1) the frequent recurrence of the same types of corporate misconduct; and (2) the lack of any action of substance in response to the red flags. [201] With the specific facts alleged in Plaintiffs' Complaint establishing that at best, Defendants simply went "through the motions" in the face of growing legal violations, Plaintiffs have properly alleged that the Defendants consciously failed to attend to their fiduciary oversight duties.

6. Defendants' Claim That Plaintiffs Mischaracterize The Section 220 Documents Is Simply Wrong

Plaintiffs have pled particularized facts sufficient to raise a reasonable doubt as to whether the Defendants acted in good faith. Plaintiffs' claims are supported by a plethora of regulatory orders, a criminal guilty plea, billions of dollars in penalties, and company documents. Defendants now try to contort the meaning of the heavily redacted internal Company documents and ask this Court to make inferences in their favor. Defendants are not entitled to such inferences on a motion to dismiss.

Defendants do not deny that Plaintiffs accurately characterized the language found in the internal company documents relied upon in the Complaint. Rather, Defendants cherry pick snippets of the documents and ask the Court to draw factual conclusions from them, even though the inferences they seek conflict with the allegations of the Complaint, including with regulators' findings. Importantly, the regulators had vastly superior access to Company records than the narrowly scoped and highly redacted documents available to Plaintiffs.

While the Defendants' efforts are improper on a motion to dismiss, a brief look at a few examples of the documents in their contextual framework reveals how weak Defendants' argument is:

> • April 2012 Minutes (Defs.Ex.3.)--Defendants do not deny that the minutes describe [Text redacted in copy.] Defendants instead assert that [Text redacted in copy.] [202] That Defendants were simply going through the motions is demonstrated by other language in the same minutes, noting that [Text redacted in copy.] That same month, the OCC entered its BSA/AML Consent Order. Further, in August 2012, just four months after Defendants [Text redacted in copy.] the FDIC/CDFI Consent Order was issued.

• January 2013 Minutes Defs.Ex.5--Defendants do not deny that Plaintiffs [Text redacted in copy.] Rather, Defendants claim that [Text redacted in copy.] The facts show otherwise. Notably, less than two months later, the FRB issued its consent order for BSA/AML violations, the *third such order in the span of a year.*

• October 2013 Minutes (Defs.Ex.8)--Defendants do not deny that Plaintiffs accurately quote the minutes, which discuss major governance issues at Citigroup's Mexican operations. Instead, Defendants [Text redacted in copy.][203] Defendants argue that [Text redacted in copy.] However, the Board had been repeatedly warned [Text redacted in copy.] including in January 2012, February 2012, and September 2012, and filed to act.[204] The minutes also discuss [Text redacted in copy.] Five months later, Citigroup's Mexican operations suffered a $400 million fraud from its dealings with Oceanografi#a, resulting from the *same type* of control failures [Text redacted in copy.]

• January 2015 Minutes (Defs.Ex. 11)--Defendants *continue to claim* that [Text redacted in copy.] In July 2015, three years after the FDIC/CDFI Consent Order, the FDIC and CDBO determined that the bank failed to implement an effective BSA/AML compliance program *over an extended period of time.* Defendants do not dispute that [Text redacted in copy.] Indeed, as Plaintiffs have alleged, [Text redacted in copy.] between February 2013 and April 2015.[205] Rather Defendants failed to take good faith steps to remediate the risk.

• July 2011 Minutes Defs.Ex. 24)--Defendants do not dispute that Plaintiffs [Text redacted in copy.] Instead, Defendants assert that [Text redacted in copy.] in July 2011.[206] However, based on regulatory actions filed in July 2015 by the OCC and the CFPB concerning these and other deceptive credit card practices, Defendants failed to take action and such practices continued for years.

Plaintiffs have pled with sufficient particularity facts that raise a reasonable doubt as to whether Defendants can objectively evaluate a demand. A motion to dismiss is not the appropriate vehicle to address Defendant's factual squabbles with these well-pleaded allegations.[207]

III. THE COMPLAINT STATES CLAIMS AGAINST DEFENDANTS

Defendants separately contend that the Complaint fails to state a claim for which relief can be granted.[208] Defendants' argument must be rejected because Plaintiffs have established that Defendants consciously failed to address gaping holes in the Company's internal controls and, therefore, that Defendants breached their fiduciary duties.

A Rule 12(b)(6) challenge will be rejected so long as a claim is "reasonably conceivable," i.e., there is a "possibility" of recovery.[209] "To state a claim for breach of a fiduciary duty, the factual allegations in a complaint must be such that they reasonably could support a finding that a fiduciary duty existed and the defendant breached that duty."[210]

It is incontrovertible that Defendants owed fiduciary duties of loyalty and care to Citigroup.[211] Defendants do not dispute this. As set forth below, the Complaint alleges that Defendants breached those duties.

A. THE COMPLAINT STATES A CLAIM AGAINST THE DIRECTOR DEFENDANTS

Plaintiffs have adequately pled facts excusing demand because the Director Defendants breached their fiduciary duties by failing to act to remedy Citigroup's inadequate risk management and compliance controls. Section II, *supra.* "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.' "[212] As the Director Defendants face a substantial threat of liability for purposes of Rule 23.1, "it follows that the Complaint states a claim against these directors for purposes of Rule 12(b)(6)."[213] Defendants concede that "the same arguments apply as to the Former Director Defendants."[214] Accordingly, the Complaint also states a claim against the Former Director Defendants.

B. THE COMPLAINT STATES A CLAIM AGAINST THE OFFICER DEFENDANTS

The Complaint states a claim against the Officer Defendants for breaching their fiduciary duties by failing to detect and remedy the misconduct alleged. Plaintiffs identified specific red flags received by the Officer Defendants and further alleged that they failed to take action in response. In addition, the Officer Defendants' particular positions required them to remain aware of risks the Company faced and corporate traumas that arose; because of these positions, it is not only "possible" that Defendants learned of additional red flags, but likely.[215]

As Citigroup's Head of Franchise Risk & Strategy and Chief Risk Officer, Leach was responsible for overseeing Compliance, Franchise Risk Architecture, Internal Audit, Operational Risk Management, Risk Management, Risk Strategy, and Strategic Regulatory Initiatives for Citigroup.[216] In this position, Leach had knowledge regarding a variety of compliance issues, including the need to improve BSA/AML controls, as well as other compliance and risk oversight at Banamex.[217]

Medina-Mora was Citigroup's co-President for years, and he served as the Chairman of the Banamex Group's Board. He also held various positions at the Banamex group and as CEO of the Global Consumer Banking business. As a result, he was actively involved in BSA/AML compliance and fraud discussions, including as a result of his participation in Board and committee meetings.[218]

Pandit and Corbat were Citigroup's CEOs from December 2007 until October 2012, and since October 2012, respectively. In addition to receiving reports as members of the Board, by virtue of their positions, Pandit and Corbat had reason to know that the Company's internal controls were deficient.[219]

Based on these allegations, it is reasonable to infer that the Officer Defendants knew that Citigroup's internal controls and risk management procedures were inadequate to detect and prevent the corporate traumas that manifested throughout the Company and that they breached their fiduciary duties by failing to take action to prevent, detect, and remedy the misconduct.[220]

C. DEFENDANTS' BREACHES ARE NOT SUBJECT TO EXCULPATION

Defendants argue that their breaches were exculpated pursuant to a Section 102(b)(7) exculpation clause in Citigroup's Certificate of Incorporation.[221] They are wrong.

First, the Delaware Supreme Court has unequivocally stated that Section 102(b)(7) does not permit exculpation of officers.[222] Accordingly, the claims against Leach and Medina Mora are not barred.

Second, Section 102(b)(7) cannot bar claims against officer-directors to the extent the defendants were acting in their capacity as officers. [223] Therefore, claims against Citigroup's officer-directors (Defendants Corbat, McQuade, and Pandit) cannot be barred. Defendant Corbat has been Citigroup's CEO since 2012. [224] Similarly, McQuade served as CEO of Citibank from July 2009 until April 2014, while all of the complained of corporate traumas took place. [225] Likewise, Pandit served as CEO of Citigroup from December 2007 until October 2012. [226] Accordingly, the claims asserted relate to Corbat, McQuade and Pandit's conduct as officers of Citigroup and cannot be exculpated by Section 102(b)(7).

Finally, exculpatory provisions can only eliminate director liability for duty of care violations, not duty of loyalty violations. [227] "The standard for *Caremark* liability parallels the standard for imposing liability when directors failed to act in good faith." [228] Indeed, a finding that the Complaint states an oversight claim prevents defendants from invoking the Company's exculpatory provision at the pleading stage. [229] Because Plaintiffs have adequately pled claims against the Director Defendants for breach of the duty of loyalty (and failure to act in good faith), Defendants cannot invoke the Company's exculpatory provision. Accordingly, this case should not be dismissed on that basis. [230]

CONCLUSION

For the foregoing reasons, Plaintiffs respectfully request that the Court deny Defendants' motion to dismiss.

DATED: November 14, 2016

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Footnotes

1 Besides the [Text redacted in copy.] government actions, the Complaint describes as background more than [Text redacted in copy.] actions which cost Citigroup and its subsidiaries in excess of $10 billion.

2 Defs.Br. 5.

3 Plaintiffs chose at this time to withdraw their claims as to Defendants Davidson, Hu and Thurm. Their motion to dismiss on the basis of a lack of personal jurisdiction is therefore moot.

5 ¶143.

7 ¶143.

8 ¶144. Defendants McQuade, O'Neill, Santomero, Zedillo, Joss, Ricciardi, and Ryan signed the 2012 order. ¶285

9 ¶¶144-45. Certain officers also raised similar BSA/AML concerns to the Compliance Committee. ¶149&n.41.

10 ¶145.

11 ¶145. After the 2012 OCC Consent Order management warned the Board that [Text redacted in copy.] Defendants Humer, O'Neill, Rodin, Santomero, Spero, Taylor, Thompson, Zedillo, Joss, Pandit, Ricciardi, and Ryan learned [Text redacted in copy.] at a meeting. ¶286-87. Shortly thereafter, management warned the Board that [Text redacted in copy.] ¶138.

12 The Board knew of this order by October 2012. ¶151-52.

13 ¶152.

14 For example, in January 2013, the Board learned of [Text redacted in copy.] Defendants Corbat, Humer, McQuade, O'Neill, Rodin, Spero, Taylor, Thompson, Zedillo, Joss, Ricciardi, and Ryan attended the meeting. ¶288.

15 For example, at a December 2012 meeting, Joss reported to Corbat, Humer O'Neill Rodin, Santomero, Spero, Talor, Thompson Ricciardi, and Ryan that [Text redacted in copy.] ¶287. The next month, at a meeting with Corbat, Humer, McQuade, O'Neill, Rodin, Spero, Taylor, Thompson, Zeillo, Joss, Ricciardi, and Ryan, the Board learned that [Text redacted in copy.] ¶288.

16 ¶153.

17 ¶159. By "Banks," the FRB refers to Citibank and BUSA. ¶160 n.48.

18 ¶159.

19 ¶160.

20 ¶290.

21 Defs.Ex. 2 at 3.

22 The Board received [Text redacted in copy.] reports between April 2013 and January 2014. The Board was warned [Text redacted in copy.] in 2014, and [Text redacted in copy.] in the first three months of 2015, [Text redacted in copy.] ¶¶291-301.

23 ¶302.

24 ¶164. Additionally, in March 2014, the Massachusetts U.S. Attorney issued grand jury subpoenas to BUSA demanding information about BSA/AML controls. Six months later, a DOJ "criminal investigation into money-laundering controls at [BUSA] uncovered potential violations serious enough to merit a fine under the [BSA]." ¶168-69.

25 ¶166.

26 ¶165.

27 ¶165. The CDBO fine was paid out of the FDIC assessment.

28 ¶167.

29 ¶171.

30 ¶172.

31 ¶215.

32 ¶174.

33 In September 2013, management discussed with the Audit Committee [Text redacted in copy.] This remained a theme of IA's 2013 year-end review, [Text redacted in copy.] The lack of maker/checker controls also manifested in a hedge fund fraud, caused by Citigroup "fail[ing] to implement a system in which [a trader's] authority was checked adequately." The issue persisted through at least July 2014. ¶175-77.

34 The Audit and Risk Committee learned as early as January 2009 that [Text redacted in copy.] ¶178 n.56.

35 ¶180.

36 Citigroup admitted that [Text redacted in copy.] ¶180 n.56; Arthur E. Wilmarth Jr., *Citigroup: A Case Study in Managerial and Regulatory Failures,* 47 IND.L.REV. 69, 119 (2013) (" '[CEO Chuck Prince] inherited a gobbledygook of companies that were never integrated, and it was never a priority of the company to invest. The businesses didn't communicate with each other. There were dozens of technology systems and dozens of financial ledgers.' ").

37 ¶178.

38 ¶182 (Audit Committee was aware of [Text redacted in copy.] in July 2011).

39 ¶183.

40 ¶184. Spero, Santomero, Ryan, O'Neill, Turley, and Thompson all learned of this at a meeting. ¶339. In fact, the matter had been addressed with the whole Board and Medina-Mora that month. Defs.Ex. 8 at 2.

41 ¶185.

42 ¶186.

43 ¶187. *The* Audit Committee was warned in September 2013 that [Text redacted in copy.] ¶188, and the entire Board received a report about this particular fraud in or before October 2013. Defs.Ex. 08.

44 ¶193-94. Defendants Corbat, Humer, O'Neill, Reiner, Rodin, Santomero, Taylor, Thompson, Turley, Zedillo, Joss, and Ryan attended a September 2013 meeting at which was discussed. ¶310.
45 ¶199.
46 ¶201.
47 ¶203
48 ¶204.
49 ¶204.
50 ¶208.
51 ¶206.
52 ¶206.
53 A Mexican court has issued arrest warrants for three Banamex employees. ¶206&n.64.
54 ¶207(emphases added).
55 ¶214
56 ¶215.
57 ¶217-19.
58 ¶217.
59 ¶217. It imposed an additional fine when Banamex failed to comply with its Corrective Action Plan. ¶218.
60 ¶219.
61 ¶224.
62 ¶226.
63 ¶233.
64 ¶233.
65 ¶233.
66 ¶235.
67 ¶235.
68 ¶235.
69 ¶236.
70 ¶237.
71 ¶321.
72 ¶237.
73 ¶238.
74 ¶238.
75 ¶238.
76 Other investigations are ongoing. Importantly, each regulator that has reprimanded Citigroup concluded that the Company and its subsidiaries did not have sufficient controls over the FX trading business. ¶¶239-43.
77 ¶239.
78 ¶254.
79 ¶255.
80 ¶256.
81 ¶263.
82 ¶¶330-33; ¶265.
83 ¶270.
84 ¶271.
85 ¶266.
86 ¶270.
87 ¶273.
88 ¶275.
89 ¶275.
90 *Id.*

91 *Wood v. Baum,* 953 A.2d 136, 140 (Del. 2008)("The *[Rales]* test applies where the subject of a derivative suit is not a business decision of the Board but rather a violation of the Board's oversight duties.").

92 *In re China Agritech, Inc. S'holder Deriv. Litig.,* 2013 WL 2181514, *15 (Del. Ch. May 21, 2013)(quoting *Rales v. Blasband,* 634 A.2d 927, 934 (Del. 1993)).

93 *Id.* at 16(quoting *Rales,* 634 A.2d at 936).

94 *In re info USA, Inc. S'holders Litig.* 953 A.2d 963, 989-90 (Del.Ch. 2007); *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart,* 845 A.2d 1040, 1046 n.8 (Del. 2004)(an evenly divided board could not objectively evaluate a demand).

95 ¶16.

96 *Id.*

97 *Id.* at *14("The requirement of factual particularity does not entitle a court to discredit or weigh the persuasiveness of well-pled allegations.").

98 *Id.*(quoting *Aronson v. Lewis,* 473 A.2d 805, 816 (Del. 1984)).

99 ***Stone*** *v.* ***Ritter****,* 911 A.2d 362, 370 (Del. 2006).

100 *LAMPERS v. Pyott,* 46 A.3d 313, 341 (Del. Ch. 2012).

101 *Reiter v. Fairbank,* 2016 WL 6081823 (Del. Ch. Oct. 18, 2016).

102 Plaintiffs withdraw Count II (Waste) and therefore do not address the sufficiency of the demand futility allegations as to Count II.

103 Defs.Br. 23-27.

104 *Del. Cty. Emp. Ret. Fund v. Sanchez,* 124 A.3d 1017, 1019 (Del. 2015).

105 *Id.* at 1021(emphasis added).

106 The cases Defendants cite are inapposite. *Desimone* referred to the need to plead facts specific to each director, rather than simply imputing knowledge. *Desimone v. Barrows,* 924 A.2d 908, 943 (Del. Ch. 2007). In *Beam,* the Court made the uncontroversial observation that demand futility is analyzed on a "claim-by-claim" basis. *Beam,* 833 A.2d at 961 n.48(assessing demand futility separately as to separate counts). *Beam,* therefore, says nothing about whether the *factual bases* for a claim that directors are conflicted should be considered separately or as a whole.

107 *See Grobow v. Perot,* 539 A.2d 180, 186 (Del. 1988)(stating that "[r]easonable doubt" for demand futility purposes "must be decided by the trial court on a case-by-case basis employing an objective analysis," and not by "rote and inelastic" criteria), *overruled on other grounds, Brehm v. Eisner,* 746 A.2d 244 (Del. 2000).

108 Defs.Br. 3, 23.

109 *Id.* at 23-25.

110 *LAMPERS v. Pyott,* 46 A.3d 313 (Del. Ch. 2012), *rev'd on other grounds, Pyott v. La. Municipal Police Emps.' Ret. Sys.,* 74 A.3d 612 (Del. 2013); *In re Massey Energy Co.,* 2011 WL 2176479 (Del. Ch. May 31, 2011); *Rosenbloom v. Pyott,* 765 F.3d 1137 (9th Cir. 2014); *Westmoreland Cnty. Emp. Ret. Sys. v. Parkinson,* 727 F.3d 719 (7th Cir. 2013).

111 *Pyott,* 46 A.3d at 341(noting that "[a] board that fails to act in the face [of red flags] makes a conscious decision, and the decision not to act is just as much of a decision as decision to act.").

112 *Pyott,* 46 A.3d at 344-55.

113 *Id.* at 352(quoting *Massey,* 2011 WL 2176479, at *20).

114 *Id.*

115 *Id.* at 358.

116 *Rosenbloom,* 765 F.3d at 1144.

117 *Id.* at 1152-54.

118 *Id.* at 1154(reversing dismissal).

119 *Westmoreland,* 727 F.3d at 719.

120 *Id.*

121 *Id.*

122 *Id.* at 728-29.

123 *Id.* at 722, 726.

124 *Massey,* 2011 WL 2176479, at *19.

125 *Id.*

126 *Id.*

127 *Id.* at *20.

128 Defs.Br. 4("the Complaint fails to adequately allege that the Directors did *nothing* to enhance or improve the Company's controls once they came to light").

129 *See, e.g., Desimone,* 924 A.2d at 940(plaintiff "ha[d] *not alleged any facts* to suggest that Sycamore's internal controls were deficient, much less that the board...had any reason to suspect that they were or that backdating was occurring"); *Guttman v. Huang,* 823 A.2d 492, 498 (Del. Ch. 2003)(complaint did not allege "the status of the company's financial controls").

130 *In re JP Morgan Chase & Co. Deriv. Litig.,* 2014 WL 3778181, at *2 (S.D.N.Y. July 30, 2014); *In re Gen. Motors Co. Deriv. Litig.,* 2015 WL 3958724, at *16 (Del. Ch. June 26, 2015)("Plaintiffs have failed to plead, on any other basis, knowledge that GM's existing systems were inadequate," alleging only "that the culture at GM provides the stand-in from which [the court] can infer the Board was consciously failing to act in the Company's interest."); ***Stone*** *v.* ***Ritter****,* 2006 WL 302558, at *2 (Del. Ch. Jan. 26, 2006), *aff'd,* 911 A.2d 362 (Del. 2006)("Plaintiffs fail to point to any facts either showing how the...scheme, or any other problems at AmSouth, waved a 'red-flag' in the face of the board. Nor do plaintiffs point to facts suggesting a conscious decision to take no action in response to red flags.").

131 727 F.3d at 722-24.

132 *Id.*

133 2011 WL 2176479, at *20.

134 *Id.* at* 19.

135 *See Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund II, L.P.,* 624 A.2d 1199, 1208 (Del. 1993)("a fairly pleaded claim of good faith/bad faith raises essentially a question of fact which generally cannot be resolved on the pleadings or without first granting an adequate opportunity for discovery").

136 *Rales,* 634 A.2d at 934(the demand futility question is limited to whether "the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt, as of the time the complaint is filed" that the board could not objectively assess demand).

137 ¶61.

138 ¶63.

139 ¶61.

140 ¶68.

141 Defs.Br. 23.

142 *See, e.g., Freuler v. Parker,* 803 F.Supp.2d 630 (S.D. Tex. *2011)(Caremark* claim not plead based solely upon bribery allegations); *Strong ex rel Tidewater, Inc. v. Taylor,* 877 F.Supp.2d 433 (E.D. La. 2012)(same).

143 Defs.Br. 27.

144 *See, e.g., In re Intel Corp. Deriv. Litig.,* 621 F.Supp.2d 165, 175 (D. Del. 2009)(red flags concerned the existence of "ongoing investigations" and a "preliminary conclusion" of wrongdoing); *In re ITT Corp. Deriv. Litig.,* 653 F.Supp.2d 453, 461-63 (S.D.N.Y. 2009)(red flags concerned the existence of investigations of alleged misconduct and eventual criminal proceedings).

145 *In re Johnson & Johnson Deriv. Litig.,* 865 F.Supp.2d 545, 566 (D.N.J. 2011).

146 For example, the "red flags" alleged in *Citigroup* and *Pandit* "amount[ed] to nothing more than indications of worsening economic conditions." *In re Citigroup, Inc. S'holder Deriv. Litig.,* 964 A.2d 106, 134 (Del. Ch. 2009); *La. Mun. Police Emps. Ret. Sys. v. Pandit,* 2009 WL 2902587, at *8 (S.D.N.Y. Sept. 10, 2009)("alleged 'red flags'...were nothing more than signs of a continued deterioration in the financial markets").

147 964 A.2d at 134.

148 *In re Goldman Sachs Grp. Inc. S'holder Litig.,* 2011 WL 4826104 (Del. Ch. Oct. 12, 2011).

149 *See, e.g., In re SAIC Inc. Deriv. Litig.,* 948 F.Supp.2d 366, 390 (S.D.N.Y. 2013)("Plaintiffs do not allege any direct path by which information about the [alleged misconduct] actually reached the Board, nor do they allege sufficiently clear and prominent red flags."); *South v. Baker,* 62 A.3d 1, 17 (Del. Ch. 2012)("the complaint nowhere alleges anything that the directors were told about the incidents, what the Board's response was, or even that the incidents were connected in any way.").

150 *See, e.g., South,* 62 A.3d at 17; *In re ITT Corp. Deriv. Litig.,* 588 F.Supp.2d 502, 511 (S.D.N.Y. 2008).

151 698 A.2d at 971.
152 *Reiter v. Fairbank,* 2016 WL 6081823, *9-12 (Del. Ch. Oct. 18, 2016).
153 *Id.* at 13.
154 *Id.*
155 ¶301.
156 Defs.Br. 26-27 n.11.
157 ***Stone***, 911 A.2d 362 at 364.
158 *Id.*
159 *Id.* at 372.
160 *Id.* at 373(emphasis added).
161 ¶166.
162 *Westmoreland,* 727 F.3d at 727(demand futile where board failed to adhere to regulatory order's requirements).
163 ¶182(as early as 2011 the Company "identified [Text redacted in copy.] (in response to the BSA fraud, a former Citigroup Vice President stated, "[y]ou know how in the U.S. everything is triple-checked and monitored...In Mexico it does not necessarily work like that...It is all informal, a system of trust and prestige, of vouching for somebody because you know them or of them").
164 ¶178.
165 ¶¶182-83, 186-87.
166 ¶¶175-77.
167 Defs.Br. 35.
168 *City of Roseville Emps. Ret. Sys. v. Crain,* 2011 WL 5042061, at *9 (D.N.J. Oct. 24, 201)(emphasis added).
169 ¶344
170 *See Caremark,* 698 A.2d at 971("a sustained or systematic failure of the board to exercise oversight...will establish the lack of good faith that is a necessary condition to liability").
171 ¶¶240-44.
172 ¶240.
173 ¶241.
174 ¶235.
175 ¶243.
176 ¶248; Defs.Ex. 15 at 12-13.
177 ¶¶72, 78-81.
178 ¶¶235-37.
179 Defs.Br. 39.
180 *See, e.g., Walt Disney Co. Deriv. Litig.,* 907 A.2d 693, 776 n.574 (Del. Ch. 2005), *aff'd,* 906 A.2d 27 (Del. 2006) ("The delegation of authority by a board to an officer does not mean that the board has completely abdicated its authority")(internal quotations omitted).
181 254-55. *In re Discover Fin. Serv. Derivative Litig.,* 2015 WL 1399282 (N.D. Ill. Mar. 23, 2015), is inapposite. There, Plaintiffs did not cite documents illustrating the Board's awareness of enforcement actions. Here, the misconduct continued for years after the Board became aware of such actions.
182 ¶264.
183 ¶265.
184 Pls.Ex.A.
185 ¶266.
186 ¶267.
187 ¶¶268, 269.
188 Defs.Br. 48.
189 ¶15.
190 "Directors of a parent board can breach their duty of loyalty if they purposely cause--or knowingly fail to make efforts to stop--action by a wholly-owned subsidiary that is adverse to the interests of the parent," *Grace Bros.,*

Ltd, v. Uniholding Corp., 2000 WL 982401, at *1, *12 (Del. Ch. July 12, 2000); *see also Refco Grp. Ltd., LLC v. Cantor Fitzgerald, L.P.,* 2014 WL 2610608, at *20 (S.D.N.Y. June 10, 2014).

191 ¶¶18-22, 24-26, 28, 29.

192 ¶¶ 264, 266.

193 Defs.Br. 29.

194 ¶¶ 281-398.

195 *Compare In re ITT Corp.,* 653 F.Supp.2d at 460 (no demand futility where "the only Director-specific allegations... are allegations regarding the individual Directors' membership on Committees of the Board,...several paragraphs discussing remedial measures taken by [two directors], and allegations regarding public statements made by [one director.]"); *South,* 62 A.3d at 17(no allegations that directors were told about red flags).

196 *Buckley v. O'Hanlon,* 2007 WL 956947 (D. Del. Mar. 28, 2007).

197 ***Stone***, 911 A.2d at 370(grounding the *Caremark* duty to ensure proper oversight in the fiduciary duty of loyalty).

198 *Massey,* 2011 WL 2176479, at *19.

199 *Id.*

200 *Id.*

201 *Id.* at 19-21("[W]hen a company has a 'record' as a recidivist, its directors and officers cannot take comfort in the appearance of compliance motion at the pleading stage" where plaintiffs allege directors were "aware of a troubling continuing pattern of non-compliance," and defendants chose to "regularly flout[]" the law).

202 Defs.Br. 30

203 Defs.Br. 37.

204 ¶341.

205 ¶302.

206 Defs.Br. 53.

207 On a Rule 23.1 motion, the Court considers only the complaint's allegations and documents incorporated by reference therein, accepts well-pled allegations as true, and makes reasonable inferences in favor of the plaintiff-as it does when considering a motion to dismiss under Rule 12(b)(6). *Beam,* 833 A.2d at 970, 976; *see also Pyott,* 46 A.3d at 358("Even under Rule 23.1, the plaintiffs receive the benefit of reasonable inferences that can be drawn from adequately pled facts."). Any incorporation of company documents does not change the pleading standard. *Amalgamated Bank v. Yahoo, Inc.,* 132 A.3d 752, 798 (Del. Ch. 2016). Plaintiffs are entitled to all reasonable inferences in their favor and all particularized factual allegations are still accepted as true. *Id.* If the documents support competing interpretations or more than one plausible inference, and the inference that plaintiffs seek is reasonable, plaintiffs--and not defendants--are entitled to the favorable inference. *Id.*

208 Defs.Br. 60.

209 *Central Mortg. Co. v. Morgan Stanley Mortg. Capital Hldgs. LLC,* 227 A.3d 531, 536, 547&n.13 (Del. 2011).

210 *Stewart v. Wilmington Trust SP Servs, Inc.,* 112 A.3d 271, 297 (Del. Ch. 2015).

211 *Gantler v. Stephens,* 965 A.2d 695, 709 (Del. 2009).

212 *China Agritech,* 2013 WL 2181514, at *24.

213 *Id.; see also Ryan v. Gifford,* 918 A.2d 341, 357 (Del. Ch. 2007) ("[W]here plaintiff alleges particularized facts sufficient to prove demand futility under the second prong *of Aronson,* that plaintiff *a fortiori* rebuts the business judgment rule for the purpose of surviving a motion to dismiss pursuant to Rule 12(b)(6)").

214 Defs.Br. 60.

215 *In re AIG, Inc.,* 965 A.2d 763, 797 (Del. Ch. 2009) (officers' roles can support an inference that the officers knew of wrongdoing).

216 ¶40.

217 ¶299.

218 ¶41. Medina-Mora is currently the non-executive Chairman Banamex's board, he was Citigroup's Co-President from January 2013 to June 2015, CEO of Global Consumer Banking from November 2011 to June 2015, and Executive Chairman of Citigroup's franchise in Mexico from 2004 to June 2015.

219 *E.g.,* ¶¶128 n.27; 149 n.41; 284, 287, 345-50.

220 *See, e.g., Stewart,* 112 A.3d at 321, 322(reasonable to infer that officer "knew that the directors were not informing themselves and not exercising their oversight responsibility" where directors ignored suggestions for addressing audit irregularities and "the same difficulties came up the following year").

221 Defs.Br. 7.

222 *See Gantler,* 965 A.2d at 709 n.37(noting that there is no statutory provision authorizing exculpation of corporate officers); *Chen v. Howard-Anderson,* 87 A.3d 648, 686 (Del. Ch. 2014)(same).

223 *Chen,* 87 A.3d at 687 ("Because the plaintiffs have assembled evidence sufficient to support claims against [the CEO] and [the CFO] in their capacity as officers, the Exculpatory Provision does not protect them.").

224 ¶17.

225 ¶20.

226 ¶32.

227 *See* DGCL § 102(b)(7) (exculpatory provisions may not eliminate or limit the liability of a director for "any breach of the director's duty of loyalty" or "acts or omissions not in good faith." 8 Del. C. § 102(b)(7)); *In re China Agritech,* 2013 WL 2181514, at *25 (no exculpation for "conduct that is not in good faith or a breach of the duty of loyalty" (quoting, ***Stone***, 911 A.2d at 367)); *Citigroup,* 964 A.2d at 124 (Section 102(b)(7) provisions exculpate "directors from personal liability for violations of fiduciary duty, except for...breaches of the duty of loyalty or actions or omissions...that involve intentional misconduct or a knowing violation of law"); *In re Ebix, Inc. S'holder Litig.,* 2014 WL 3696655, at *27 (Del. Ch. Jul. 24, 2014)("Even under the broadest Section 102(b)(7) provision permitted under Delaware law, however, directors are still personally liable for damages from breaches of the duty of loyalty or bad faith conduct").

228 *Id.* at *25.

229 *Id.* at *26.

230 *See, e.g., Massey,* 2011 WL 2176479, *20("a fiduciary of a Delaware corporation cannot be loyal to a Delaware corporation by knowingly causing it to seek profit by violating the law"); *Citigroup,* 964 A.2d at 124.

End of Document

2015 WL 5089162 (Cal.Super.) (Expert Report and Affidavit)
Superior Court of California.
San Bernardino County

Cathy CARRILLO and Steve Lopez, Plaintiffs,
v.
SAN ANTONIO COMMUNITY HOSPITAL, Norwalk Community Hospital, Inland Urology Medical Group; Team Health, Mountainview Physicians, Aaron Nguyen, M.D., Sandra Donnelly, M.D., James Fisgus, M.D., Thomas Cho, M.D , and Does 1 through 100, inclusive, Defendants.

No. CIVRS 1305931.
February 3, 2015.

Declaration of Michael Ritter, M.D. in Support of Plaintiffs' Opposition To Defendant Norwalk Community Hospital And Sandra Donnelly, M.D.'s Motion For Summary Judgment

Case Type: Medical Malpractice-Facility >> Hospital
Case Type: Medical Malpractice-Physicians & Health Professionals >> Emergency Physician
Case Type: Medical Malpractice-Procedures & Treatment >> Medication
Case Type: Medical Malpractice-Procedures & Treatment >> Failure to Diagnose/Treat
Jurisdiction: San Bernardino County, California
Name of Expert: Michael Ritter, M.D.
Area of Expertise: Health Care-Physicians & Health Professionals >> Emergency Physician

Representing: Plaintiff

James S Bostwick, Esq. (042718), Bostwick & peterson, LLP, Four Embarcadero Center, Suite 750, San Francisco, CA 94111 5994, Telephone: (415) 421-8300, Fax. (415)421-8301, Attorneys for Plaintiffs.

I, Michael Ritter, M.D., declare:

1. I received my undergraduate degree from California State University, Fullerton in 1987 received my Doctorate of Medicine degree in 1991 from University of California, Irvine, following which I completed a residency at UC Irvine Medical Center in 1994. I have been Emergency Department Attending Physician at Mission Hospital and Regional Medical Center & Children's Hospital at Mission since 1996 and Medical Director since 2012

2. On the basis of my education, training and experience I am familiar with the standard of care required of physicians practicing in emergency medicine in California at all times relevant to this action.

3. Based on my experience as a medical director of an emergency department I am familiar with the standard of care required of emergency room personnel, nurses, technicians as well as emergency room protocol in California at all times relevant to this action.

4. All of the facts contained in this declaration are stated from my own personal knowledge from either a review of the records in this matter or based on my education, training and experience and, if called as a witness in this matter, I could and would competently testify thereto in a court of law

5. All of the opinions contained in this declaration are stated to a reasonable degree of medical certainty on the basis of my education, training, extensive experience, and along with my years of clinical treatment and management of patients with complaints similar to those described Cathy Carrillo Lopez, unless otherwise stated.

6. I have been retained by the Law Offices of Bostwick & Peterson LLP, to determine whether the care and treatment Defendants, Norwalk Community Hospital and Sandra Donnelly, M.D provided to Plaintiff Cathy Carrillo Lopez during the pertinent time period complied with the standard o care for emergency medicine and practice in the community at such time as said care and treatment was rendered.

7. For the purpose of forming my opinions in this matter, I have reviewed and I am familiar with each of the following.

a. Medical records of Cathy Carrillo from Norwalk Community Hospital.

b. Medical records of Plaintiff Cathy Carrillo from San Antonio Community Hospital

c. The deposition transcript of Sandra Donnelly, M.D

8. Plaintiff was a 48 year old female admitted to Norwalk Community Hospital ER via ambulance on Dec 26th for sudden onset severe right lower quadrant abdominal pain while at work. He pain had started approximately one hour earlier and she had nausea.

9 Plaintiff was triaged at 12.35 by a nurse with a normal exam other than right lower quadrant abdominal pain and nausea. Vitals showed blood pressure of 122/71, pulse of 89, respiration rate of 26, 02 sat of 99% and a temperature of 98.4

10 At 12:40 Defendant Donnelly evaluated Plaintiff She confirmed the presence of right lower quadrant abdominal pain for the past hour radiating to the back. It was a sharp pain ranked 10/10. Dr Donnelly's impression was that Plaintiff likely had a kidney **stone**. Her plan was to administer fluids, give pain and nausea medications, and do a workup with labs and imaging to determine if the diagnosis was correct and if there was evidence of complications such as infection. These studies are important because it is necessary to rule out the presence of infection when there is a kidney **stone** obstructing the ureter Kidney **stones** that are accompanied by infection are a urological emergency because the area above the **stone** (ureter and kidney) is highly vascular and such infections can evolve quickly into blood borne infections (bacteremia) which can be life threatening.

11 The blood work revealed the white count was normal, however this does not rule out an early infection. No cultures were ordered of either the blood or the urine. Plaintiff had low potassium which was treated.

12. The urinalysis showed blood in the urine which is typical with an obstructing **stone**, it also showed small leukocyte esterase which can be present if there is a urinary tract infection (it is checked in order to see if infection is present in the urine), 5 to 10 white blood cells (normal is 0 to 5 - if elevated this indicates the presence of infection) and a “few” bacteria (urine is supposed to be sterile and the presence of bacteria is also indicative of an infection). This is indicative of a urinary tract infection until proven otherwise.

13 Dr Donnelly recognized that the urinalysis was abnormal, but chose to consider it a false positive result caused by not obtaining a "clean catch" of her urine. (If the urine is not sampled in mid-stream it can pass over the external skin/labia and this can contaminate the urine sample with bacteria) Since there were a "few" epithelial cells this does not constitute a contaminated sample. She did not order another urine sample or request that the patient be catheterized to be assured they had obtained a "clean catch" for analysis.

14 The ultrasound ordered was interpreted as showing a right kidney **stone** of 1.2 x 1.0 cm. They did not find evidence of any backup into the kidney Ultrasounds may provide helpful information, but are limited in efficacy as they may miss the presence of smaller **stones**, may miss an obstruction and are not considered as effective as a CT study to rule out hydronephrosis (backup into the ureter or kidney) No CT was done.

15 Plaintiff was treated symptomatically for her pain and nausea by the medications she received. She was then discharged with prescriptions for pain and nausea medication and advised to follow up with her primary physician within two days.

16 Based on my review of the aforementioned records and the deposition of Dr Donnelly it is my opinion that Dr Donnelly and the staff at Norwalk Community Hospital breached the standard of care for diagnosis and treatment of this patient.

a. An essential element of the workup of renal calculus is proper imaging and a reliable urinalysis to rule out the presence of infection. With blood in the urine and severe pain it is highly likely there is a **stone** in the ureter with obstruction. It is important to obtain a urinalysis and if it is positive the patient must be given broad spectrum antibiotics, urology consult obtained and the patient admitted for observation and care. Here the urinalysis was positive but the results were discounted.

b. Dr Donnelly clearly recognized the requirement to obtain a urinalysis, but when the findings came back positive for likely infection she chose to assume they were the results of a contaminated sample. She chose to invalidate the results of test she needed to obtain in order to comply with the standard of care. She could have solved this problem by simply ordering another urine sample either by "clean catch" (supervised by a nurse) or catheterization sample (obtained by a nurse); this was not done. If it is worth ordering a test (and here the test was essential), it is worth getting a valid result for that critical test.

c. Urine cultures should have been obtained. If they had been they would have likely grown out the e coli and using the sensitivities the antibiotics could have been tailored to her infection.

d. Given the severe pain and blood in the urine a CT should also have been done to determine if there was a calculus in the ureter, its size and whether there was any back flow or hydronephrosis.

e. The nursing staff should have properly educated Cathy Carrillo on how to obtain a "clean catch" of urine for the urinalysis. If this indeed was not a "clean catch" then they did not perform their job in conformance with the standard of care.

f. In summary, Cathy Carrillo did show signs of an infection based on the 5 - 10 white cells in her urine and the bacteria found. If this was not a valid urine sample then another test should have been done to provide valid results for evaluation. They should have had the urine cultured and she should have been given a CT imaging study Failure to perform these basic steps to rule out infection was a breach of the standard of care.

17 The Plaintiff was admitted to San Antonio Community Hospital on Dec. 28th with sepsis from her kidney **stone**. This led to septic shock and she ultimately lost portions of all four of her extremities as a result. It is my opinion that the same infection was present in the early stages when she was seen at Norwalk by Dr Donnelly The failure to diagnose her infection at Norwalk allowed it to smolder for the intervening two days and as a result she was seriously ill when seen at the San Antonio Community Hospital ER. It is my opinion that if standard of care had been followed by Dr Donnelly and the personnel at Norwalk, Cathy Carrillo's infection would have been diagnosed, treated and cured in a timely manner She would not have developed septic shock and would not have lost her extremities.

End of Document

2000 WL 35923633 (Tex.Dist.) (Verdict and Settlement Summary)

WEST'S JURY VERDICTS - TEXAS REPORTS

Dentist Collects $70.5K Following Breach of Contract, Fraud Suit

District Court of Texas, 133rd Judicial District, Harris County.

Erwin **Ritter** Constr. Co. v. Smith

Type of Case:
Contracts • Breach

Contracts • Construction Contracts

Contracts • Quantum Meruit

Intentional Torts • Conspiracy

Fraud & Misrepresentation • Fraud

Fraud & Misrepresentation • Negligent Misrepresentation

Real Property • Foreclosure

Consumer Protection • Deceptive Acts/Practices

Specific Liability: Dentist refused to pay contractor for construction improvements made to dental practice, causing economic loss to contractor

General Injury: Monetary damages

Jurisdiction:
State: Texas
County: Harris

Related Court Documents:
Plaintiff's second amended original petition: 2000 WL 35836923

Defendant's first amended original answer and counterclaim: 2000 WL 35887748

Judgment: 2000 WL 35831866

Case Name: Erwin **Ritter** Construction Company v. Bruce W. Smith, DDS, *et al*

Docket/File Number: 1999-45161

Verdict: Plaintiff, $18,174.44; reduced in judgment to $0

Verdict Range: $1 - 49,999

Verdict Date: Nov. 7, 2000

Judge: Kathleen Stone
Attorneys:
Plaintiff: Steven Engelhardt, Houston, Texas
Defendant: Jeffrey L. Dorrell, Houston, Texas

Trial Type: Jury
Breakdown of Award:
$18,174.44 to plaintiff from defendant Smith for breach of contract damages
The court reduced the plaintiff's award, in final judgment, to $0, and subsequently awarded defendant/ counterclaimant Smith $70,524.23.

Summary of Facts:
Erwin Ritter Construction Company reportedly entered into a contract with Bruce W. Smith, DDS, June 30, 1998, to make improvements to Smith's dental practice in Houston, Texas. Ritter and Smith apparently discussed additional work requests, and entered into an oral novation to compensate Ritter on account for additional work performed. Smith allegedly accepted the work and proposed paying in installments on the outstanding balance Nov. 9. According to Ritter, he agreed to allow smith to pay the balance due in monthly installments of $1,000 on the 15th of each month if the payments were timely made. Smith allegedly ratified the novation by paying Ritter $69,783.11 but failed to pay the monthly installment April 15, 1999, and had a balance due of $70,739.15.

Ritter reportedly filed an affidavit of mechanic's and materialman's lien affidavit Aug. 23, 1999 in Harris County, and filed an amended affidavit Oct. 21. Following this, Smith entered into an agreement with Robert A. Carroll to set up Aldwych Group Inc. (AGI) and Aldwych Group of Texas Ltd. (AGT). According to Ritter, the sole purpose of setting up the Aldwych companies was to defraud Ritter and insulate Smith and Carroll from any liability related to the construction improvements.

Ritter filed a lawsuit against Smith, Carroll, AGI and AGT in Harris County District Court. In the plaintiff's second amended original petition, it asserted claims against the defendants for breach of contract, suit on sworn account, *quantum meruit*, conspiracy, fraud, foreclosure and violations of Tex. Bus. Com. Code Ann. 24.03.

The plaintiff sought to recover the amount of the remaining balance due, prejudgment interest, postjudgment interest and attorney fees. Further, the plaintiff sought exemplary damages in order to make an example out of the defendants.

Smith apparently filed a counterclaim against the plaintiff. In his first amended original answer and counterclaim, Smith asserted claims against the plaintiff for breach of contract, negligent misrepresentation, usury under the Texas finance code, unsupported pleadings presented for an improper purpose, and for making false, misleading or deceptive acts or practices and committing unconscionable actions under the Texas Deceptive Trade Practices Act.

Court: District Court of Texas, 133rd Judicial District, Harris County.

End of Document

2017 Illinois House Resolution No. 1122, Illinois One
Hundredth General Assembly - Second Regular Session

ILLINOIS RESOLUTION TEXT

TITLE: MEMORIAL-NORTHICA H. STONE

VERSION: Introduced
May 22, 2018
House, Rep. Emanuel Chris Welch
Image 1 within document in PDF format.
SUMMARY: Mourns the death of Northica Hillery-Stone of Bellwood.

TEXT:

HOUSE RESOLUTION

WHEREAS, The members of the Illinois House of Representatives are saddened to learn of the death of Northica Hillery-Stone of Bellwood, who passed away on May 16, 2018; and

WHEREAS, Northica Hillery-Stone graduated from Washington Elementary School and Proviso East High Schools in Maywood; she attended Roosevelt University, DePaul University, and Fisk University, and holds a certificate in Community Law from the John Marshall School of Law; and

WHEREAS, Northica Hillery-Stone was a lifelong member of the Second Baptist Church; at the age of 15, she was elected as director of the Second Baptist Adult Gospel Chorus and served in that position for over 25 years; she served in many other capacities, including Sunday school national delegate, soloist, president of the Hayden Memorial Scholarship Committee, Women's Day speaker, and seminar facilitator; and

WHEREAS, Northica Hillery-Stone was the longtime head of the nonprofit Operation Uplift, founded by her husband in 1968; and

WHEREAS, Northica Hillery-Stone was a longtime community activist, beginning as a charter member of Maywood's First

NAACP Youth Council; she represented the area at one of the first "Marches on Washington" rallies in 1949; she founded the West Town Museum of Cultural History in Maywood, where she served for decades as the chief archivist; the West Town opened in 1995 as a division of Operation Uplift and has become a gathering place for various community events and social functions; she and her staff were featured in the Chicago Tribune for discovering the Ten Mile Freedom House Underground Railroad site in Maywood and their efforts to erect a permanent memorial in Maywood; she was also responsible for obtaining a historic preservation status for the home and street where famed chemist Dr. Percy L. Julian lived while residing in Maywood, Percy L. Julian Way; and

WHEREAS, Northica Hillery-Stone and her husband, George, organized block clubs, and were active in local Boy Scout Troop 123 and served as P.T.O parents; and

WHEREAS, Northica Hillery-Stone received many awards for her endeavors, including recognition from the Chicago United Way, Quaker Oats, the McDonald's Black Owners Association, the Mahogany

Foundation, WVON The Talk of Chicago, the National Council of Negro Women, Dr. Dorothy Height, Congressman Danny K. Davis, the National Association of Colored Women and Aunt Jemima Brands, Cook Country Presidents' John H. Stroger Jr. and Toni Preckwinkle, the Osco Jewel Corps. Hidden Jewel of the

Community, Who's Who In American Executives, and former Presidents' George W. Bush and Bill Clinton; and

WHEREAS, Northica Hillery-**Stone** is the mother of two sons, the late Theophilous Scott Jr. and George Ellis **Stone** II; therefore, be it

RESOLVED, BY THE HOUSE OF REPRESENTATIVES OF THE ONE HUNDREDTH GENERAL ASSEMBLY OF THE STATE OF ILLINOIS, that we mourn the passing of Northica Hillery-**Stone**, and extend our sincere condolences to her family, friends, and all who knew and loved her; and be it further

RESOLVED, That a suitable copy of this resolution be presented to the family of Northica Hillery-**Stone** as an expression of our deepest sympathy.

End of Document

2017 TN REG TEXT 463222 (NS)

Tennessee Regulation Text - Netscan
TN ADC 0780-02-01-.02, 04, 05, 07, 11, 15, 20, 22
Rulemaking Hearing Rules
December 23, 2017
Department of Commerce and Insurance

Electrical Installations

Electrical Installations; Adoption by Reference; Inspections; Permits; Special Occupancies; Dwelling Units; Used Manufactured Homes; Local Government Authorization to Perform Electrical Inspections; Boat Docks and Marinas

TN ADC 0780-02-01-.02

TN ADC 0780-02-01-.02

TN ADC 0780-02-01-.04

TN ADC 0780-02-01-.04

TN ADC 0780-02-01-.05

TN ADC 0780-02-01-.05

TN ADC 0780-02-01-.07

TN ADC 0780-02-01-.07

TN ADC 0780-02-01-.11

TN ADC 0780-02-01-.11

TN ADC 0780-02-01-.15

TN ADC 0780-02-01-.15

TN ADC 0780-02-01-.20

TN ADC 0780-02-01-.20

TN ADC 0780-02-01-.22

TN ADC 0780-02-01-.22

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Sequence Number: 12-14-17

Rule ID(s): 6666

File Date: 12/19/17

Effective Date: 3/19/18

Rulemaking Hearing Rule(s) Filing Form

Rulemaking Hearing Rules are rules filed after and as a result of a rulemaking hearing (Tenn. Code Ann. § 4-5-205).

Pursuant to Tenn. Code Ann. § 4-5-229, any new fee or fee increase promulgated by state agency rule shall take effect on July 1, following the expiration of the ninety (90) day period as provided in § 4-5-207. This section shall not apply to rules that implement new fees or fee increases that are promulgated as emergency rules pursuant to § 4-5-208(a) and to subsequent rules that make permanent such emergency rules, as amended during the rulemaking process. In addition, this section shall not apply to state agencies that did not, during the preceding two (2) fiscal years, collect fees in an amount sufficient to pay the cost of operating the board, commission or entity in accordance with § 4-29-121(b).

Agency/Board/Commission: Department of Commerce and Insurance

Division: Fire Prevention

Contact Person: Leigh Ferguson

Address: 500 James Robertson Parkway

Zip: 37243

Phone: 615-360-4435

Email: leigh.j.ferguson@tn.gov

Revision Type (check all that apply):

X Amendment

_____ New

_____ Repeal

Rule(s) (**ALL** chapters and rules contained in filing must be listed here. If needed, copy and paste additional tables to accommodate multiple chapters. Please make sure that **ALL** new rule and repealed rule numbers are listed in the chart below. Please enter only **ONE** Rule Number/Rule Title per row)

Chapter Number Chapter Title

0780-02-01 Electrical Installations

Rule Number Rule Title

0780-02-01-.02 Adoption by Reference

0780-02-01-.04 Inspections

0780-02-01-.05 Permits

0780-02-01-.07 Special Occupancies

0780-02-01-.11 Dwelling Units

0780-02-01-.15 Used Manufactured Homes

0780-02-01-.20 Local Government Authorization to Perform Electrical Inspections

0780-02-01-.22 Boat Docks and Marinas

Place substance of rules and other info here. Please be sure to include a detailed explanation of the changes being made to the listed rule(s). Statutory authority must be given for each rule change. For information on formatting rules go to http://sos-tn-gov-files.s3.amazonaws.com/forms/Rulemaking%20Guidelines_September2016.pdf.

Amendments

Chapter 0780-02-01

Electrical Installations

Rule 0780-02-01.02 Adoption by Reference shall be amended by deleting the rule in its entirety and substituting the following so that the new rule shall read as follows:

(1) Unless otherwise provided by applicable law or the provisions of this chapter, the required minimum standards for materials, installations, use of facilities, equipment, devices and appliances conducting, conveying, consuming or using electrical energy in, or in connection with, any building, structure, or any premises located in the State of Tennessee shall be those prescribed in the National Electrical Code, 2017 edition, published by the National Fire Protection Association, 1 Batterymarch Park, Quincy, Massachusetts 02169, effective October 1, 2018, except that:

(a) Section 110.24, Available Fault Current shall be optional; and

(b) Arc Fault Circuit Interrupters (AFCIs) shall be optional for bathrooms, laundry areas, garages, unfinished basements, which are portions or areas of the basement not intended as habitable rooms and limited to storage, work or similar area, and for branch circuits dedicated to supplying refrigeration equipment.

Authority: T.C.A. §§ 68-102-113 and 68-102-143.

Rule 0780-02-01.04 Inspections shall be amended by deleting the rule in its entirety and substituting the following so that the new rule shall read as follows:

(1) Inspections of electrical installations may be conducted by deputy inspectors appointed under contract with the Commissioner of Commerce and Insurance pursuant to T.C.A. § 68-102-143. In circumstances where the need arises as determined by the Commissioner of Commerce and Insurance, or designee, deputy fire marshals are authorized to conduct inspections of electrical installations.

(a) Fees for such inspections for services, including all circuits connected thereto, based on total ascertainable ampere capacity, are specified in Tenn. Comp. R. & Regs. 0780-02-01-.21. If the total ampere capacity is not ascertainable, the inspector may negotiate the fee based on the estimated number of required inspections; however, any such fee shall be subject to review and approval by the Commissioner of Commerce and Insurance, or designee, prior to issuance of a permit.

(b) Fees charged for additional inspections, including inspections necessitated by rejections and inspections for circuits not previously connected to the service, shall be based on the ascertainable ampere capacity of the service or ascertainable ampere capacity of the previously unconnected circuit, and shall not exceed the maximum amounts specified in Tenn. Comp. R. & Regs. 0780-02-01-.21.

(c) Inspectors may not charge mileage in excess of the standard travel reimbursement rate, as determined by the Tennessee Department of Finance and Administration, per mile each way for any special trip(s) requested by a property owner or contractor. This mileage charge must be approved in advance by the Commissioner of Commerce and Insurance, or designee.

(2) (a) Inspections shall be required on:

1. Complete new installations:

2. HVAC equipment;

3. New services, re-connections, or changes in services to existing installations;

4. Additions to existing installations, such as swimming pools, water well pumps to the wellhead, motor installations, additional rooms or spaces to existing buildings, grain drying equipment and out buildings;

5. Heat cable installations before being concealed by plaster, sheet rock, or other methods;

6. Conduit or raceways in or under masonry before covering with concrete or other permanent materials;

7. Conductors or raceways installed in all structures. This inspection is required prior to the concealing of such conductors or raceways by wall covering materials or by insulation;

8. Temporary services, which include temporary service poles and temporary service releases; and

9. Electrical signs.

(b) A minimum of two (2) inspections shall be required on wiring installed within or on public and private buildings or other structures. The installer shall notify the electrical inspector in writing whenever any part of a wiring installation is to be hidden from view by insulation or the permanent placement of part of the building. No wiring or raceways shall be concealed until it has been inspected and approved by the inspector. A final inspection shall be requested upon completion of the entire electrical installation.

(3) When the initial ("rough-in") inspection is conducted:

(a) All applicable circuit conductors and outlet boxes shall be installed;

(b) All joints shall be made; and

(c) All grounding connections shall be in compliance with Section 300.10 of the 2017 edition of the National Electrical Code except as set forth in the exceptions enumerated in this subparagraph.

1. Exception No. 1: Where that portion of an installation which constitutes service conductors and equipment is changed or modified.

2. Exception No. 2: Where all wiring or raceway is exposed.

3. Exception No. 3: The requirements of (a) above shall not apply where inspection is performed on raceway systems only.

(4) The electrical contractor, the mechanical contractor, or the permit holder shall be responsible for ensuring the inspector has access to the site for inspection.

(5) The permit holder shall notify the inspector when the electrical installation is ready for inspection.

(6) Except as provided in Tenn. Comp. R. & Regs. 0780-02-01-.05(2) and for installers licensed in accordance with T.C.A. Title 69, Chapter 10, the inspector shall not issue a final certificate of approval on an installation performed by any person, firm, corporation or legal entity not duly licensed in accordance with T.C.A. Title 62, Chapter 6.

(7) It is not intended that electric service to an existing installation be disrupted pending inspection of additions or changes to such service; however, an inspection shall be required within seven (7) days of re-connection by the Power Supplier.

(8) Whenever service equipment has been changed out or upgraded on any existing structures, a safety inspection will be conducted pursuant to T.C.A. § 68-102-143(5).

(9) Inspections shall not be required on:

(a) Minor repair work, such as replacement of lamps or connection of portable devices to suitable receptacles which have been permanently installed; and

(b) Installation, alteration, or repair of electric wiring or equipment installed by an electrical distribution agency for use in the generation, transmission, distribution, or metering of electrical energy.

(10) The inspector shall not issue a final certificate of approval on an installation if a building permit has not been obtained, if required, plans have not been reviewed and approved by the Department of Commerce and Insurance, if required, or all inspections have not been performed pursuant to Tenn. Comp. R. & Regs. 0780-02-23-.07.

(11) For residential and commercial buildings, electrical power shall be supplied to the building in order for inspector to perform final inspection.

Authority: T.C.A. §§ 68-102-113, 68-102-143, and 68-102-150.

Paragraph (1) of rule 0780-02-01.05 Permits shall be amended by deleting the paragraph in its entirety and substituting the following so that the new paragraph (1) shall read as follows:

(1) No electrical wiring on which an inspection is required by this chapter shall be installed without securing an electrical permit from the power distributor, local building official, Commissioner, or designee, or other issuing agent authorized by the Commissioner, or designee. The permit shall be secured in the area where the work is to be performed; unless, the permit is secured from the Commissioner, or designee. Issuing agents may charge a fee of no more than five dollars ($5.00) for the issuing of a permit. This fee is in addition to all applicable inspection fees in Tenn. Comp. R. & Regs. 0780-02-01-.21.

Authority: T.C.A. §§ 68-102-113, 68-102-143, and 68-102-150.

Paragraph (3) of rule 0780-02-01.05 Permits shall be amended by deleting the paragraph in its entirety and substituting the following so that the new paragraph (3) shall read as follows:

(3) No permit shall be required for installation of electrical systems by manufacturers of factory manufactured structures, recreational vehicles, or modular building units. This rule does not exempt owners of any manufactured home, recreational vehicle or modular building unit from the required installation permit and inspection governed by this chapter.

Authority: T.C.A. §§ 68-102-113, 68-102-143, and 68-102-150.

Paragraph (9) of rule 0780-02-01.05 Permits shall be amended by deleting the paragraph in its entirety and substituting the following so that the new paragraph (9) shall read as follows:

(9) If a refund for a permit fee for inspection is requested, eighty-five percent (85%) of the permit fee, the fee that would have been paid to the inspector for the inspection, will be refunded. The remaining fifteen percent (15%) of the permit fee is non-refundable to cover administrative and processing costs. Requests for refunds shall be made to the Division of Fire Prevention on the applicable form, completed in full, prior to an inspection being performed.

Authority: T.C.A. §§ 68-102-113, 68-102-143, and 68-102-150.

Paragraph (2) of rule 0780-02-01.07 Special Occupancies shall be amended by deleting the paragraph in its entirety and substituting the following so that the new paragraph (2) shall read as follows:

(2) Conductors serving swimming pools which originate at a dwelling unit service equipment or sub-panel located on the interior of the dwelling unit may be installed utilizing the appropriate wiring methods contained in Chapter 3 of the 2017 edition of the National Electrical Code. The wiring method shall comply with Article 680, 2017 edition of the National Electrical Code regarding that portion of the installation on the exterior of the dwelling unit.

Authority: T.C.A. §§ 68-102-113, 68-102-143, and 68-102-150.

Rule 0780-02-01-.11 Dwelling Units shall be amended by deleting the rule in its entirety and substituting the following so that the new rule shall read as follows:

(1) Where installed as separate units, ovens and cooktop units shall be served by individual circuits.

(2) Only designated circuits shall be energized following a "service release" inspection. Such an inspection shall only be valid for a period of forty-five (45) days from the date of inspection.

(3) All electrical connection, including HVAC equipment, shall be completed and inspected prior to final approval pursuant to T.C.A. §§ 68-102-143(c) and (e), except as defined in paragraph (2) of this section.

(4) No newly constructed one-family or two-family dwelling shall be approved for connection of electric service on a permanent basis under T.C.A. § 68-102-143, unless the dwelling is equipped with a smoke alarm that has been:

(a) Listed in accordance with the standards of Underwriters Laboratories, or another testing agency or laboratory accepted by the state fire marshal; and

(b) Installed in accordance with the building construction safety standards adopted pursuant to T.C.A. § 68-120-101 and in accordance with the manufacturer's directions, unless those directions conflict with applicable standards adopted by the state fire marshal. Notwithstanding the building construction safety standards adopted pursuant to T.C.A. § 68-120-101, battery operated smoke alarms shall be permitted when installed in buildings without commercial power.

(5) Service equipment shall have only one (1) main means of disconnecting services of two hundred twenty-five (225) amps or below.

(6) The installation of receptacles for island counter spaces and peninsular counter spaces below the countertop shall be optional.

(7) Receptacles shall not be required in the wall space behind doors which may be opened fully against a wall surface. Wall space measurement shall begin at the edge of the door when fully opened.

(8) Light fixtures in crawl spaces shall have guarded covers.

(9) Occupancy of a dwelling shall be prohibited before final inspection has been completed and approved.

(10) In Article 334.15(C) of the 2017 edition of the National Electrical Code, Nonmetallic-Sheathed Cable shall not be required to be run through bored holes in unfinished basements and crawl spaces with less than four feet (4') and six inches (6") of clearance.

Authority: T.C.A. §§ 68-102-113, 68-102-143, 68-102-150 and 68-120-111.

Paragraph (1) of rule 0780-02-01.15 Used Manufactured Homes shall be amended by deleting the paragraph in its entirety and substituting the following so that the new paragraph (1) shall read as follows:

(1) Manufactured homes shall have listed, enclosed-type service-entrance equipment located inside the manufactured home, with proper rated overcurrent protection for each branch circuit. Overcurrent protection for circuits of twenty (20) amperes or less may be either circuit breakers, or plug fuses and fuse holders of Type "S", and shall be of the time-delay type. The manufactured home disconnecting means located inside shall be fed from an outside location with a feeder from the main service entrance for such manufactured home. If the supply or feeder from the main service to the disconnecting means located inside does not have a grounding conductor as required by Article 550 of the 2017 edition of the National Electrical Code, one shall be installed.

Authority: T.C.A. §§ 68-102-113, 68-102-143, 68-102-147, and 68-102-150.

Subparagraph (a) of paragraph (1) of rule 0780-02-01-.20 Local Government Authorization to Perform Electrical Inspections shall be amended by deleting the subparagraph in its entirety and substituting the following so that the new subparagraph (a) shall read as follows:

(1)

(a) Pursuant to T.C.A. § 68-102-143(b)(1), the Commissioner of Commerce and Insurance may authorize a local government to conduct electrical inspections through the local government's appointed deputy inspectors. This inspection authority shall cover all types of electrical installations in accordance with the law, except for state owned or state leased properties which remain under the jurisdiction of the Commissioner.

Authority: T.C.A. §§ 68-102-113 and 68-102-143(b)(1).

Rule 0780-02-01-.22 Boat Docks and Marinas shall be amended by deleting the rule in its entirety and substituting the following so that the new rule shall read as follows:

(1) Safety inspections of boat docks and marinas shall include, but are not limited to, a review of all sources of electrical supply, including ship-to-shore power pedestals, submergible pumps, and sewage pump-out facilities, that could result in unsafe electrical current in the water for the purpose of ensuring compliance with the standards for maintenance of electrical wiring and equipment that were applicable to the marina at the time of installation.

(2) (a) In the event that a deficiency is found during a safety inspection, any subsequent inspection required for the inspection of repairs made to address such deficiency shall be conducted by a deputy electrical inspector commissioned under T.C.A. § 68-102-143, and in accordance with T.C.A. § 68-102-143 and Tenn. Comp. R. & Regs. 0780-02-01.

(b) The permit fee for inspection of boat docks and marinas are negotiable based upon the number of subpanels, panels and the ampere capacity of service; however, any such fee shall be subject to review and approval by the Commissioner of Commerce and Insurance, or designee.

(3) Any main overcurrent protective device installed or replaced on or after April 1, 2015, that feeds a marina shall have ground-fault protection and meet all requirements in Article 555.3 in the edition of the National Electrical Code adopted in Tenn. Comp. R. & Regs. 0780-02-01-.02.

(4) Inspections shall be performed in accordance with the adopted electrical code edition effective at the time of installation. If the time of installation cannot be determined, the installation shall be inspected in accordance with the pertinent section related to Marinas and Boatyards, Article 555 in the edition of the National Electrical Code adopted in Tenn. Comp. R. & Regs. 0780-02-01-.02, unless otherwise authorized by the Commissioner of Commerce and Insurance, or designee.

(5) The regulation regarding a maximum of one thousand (1000) volts phase to phase being permitted in yard and pier distribution systems as specified in Article 555.4, Distribution System of the edition of the National Electrical Code adopted in Tenn. Comp. R. & Regs. 0780-02-01-.02, may be exceeded if written documentation is submitted from an engineer licensed in the State of Tennessee approving the additional voltage.

* If a roll-call vote was necessary, the vote by the Agency on these rulemaking hearing rules was as follows:

Board Member Aye No Abstain Absent Signature (if required)

N/A

I certify that this is an accurate and complete copy of rulemaking hearing rules, lawfully promulgated and adopted by the Commissioner of Commerce and Insurance (board/commission/ other authority) on _____ (mm/dd/yyyy), and is in compliance with the provisions of T.C.A. § 4-5-222.

I further certify the following:

Notice of Rulemaking Hearing filed with the Department of State on: July, 14, 2017

Rulemaking Hearing(s) Conducted on: (add more dates). September 11, 2017

Date: 11/20/17

Signature: _____

Name of Officer: Julie Mix McPeak

Title of Officer: Commissioner of Commerce and Insurance

Subscribed and sworn to before me on: 11/20/17

Notary Public Signature: _____

My commission expires on: 1/15/20

Agency/Board/Commission: _____

Rule Chapter Number(s): _____

All emergency rules provided for herein have been examined by the Attorney General and Reporter of the State of Tennessee and are approved as to legality pursuant to the provisions of the Administrative Procedures Act, Tennessee Code Annotated, Title 4, Chapter 5.

Herbert H. Slatery III

Attorney General and Reporter

12/18/2017

Date

Department of State Use Only

Filed with the Department of State on: 12/19/17

Effective on: 3/19/18

Tre Hargett

Secretary of State

Public Hearing Comments

One copy of a document that satisfies T.C.A. § 4-5-222 must accompany the filing.

Comments 1-17 were received during the public hearing on September 11, 2017. The remaining comments were received in writing during the open comment period.

Comment 1

Mr. Keith Waters from Schneider Electric spoke in support of adopting the 2017 NEC without amendment. Waters highlighted the differences between the 2008 and the 2017 versions, including the expanded protection against electrocution risk by increasing the requirement of AFCI and GFCI devices. He also highlighted the new installation guidelines for PV solar electrical systems and for energy storage systems.

Response 1

The Department thanks Mr. Waters for his comments and for participating in the hearing.

Comment 2

Mr. Charlie Monks from Eaton Corporation, former volunteer firefighter and electrician spoke about the benefits AFCIs can provide in a home. He also spoke to the difference in price and estimated that it would be

an increase of about $500 per home. Mr. Monks addressed reliability of the product and noted that AFCIs have clear installation guidelines, are no more labor intensive than other devices and have diagnostic codes available to assist in troubleshooting.

Response 2

The Department thanks Mr. Monk for his comments and for participating in the hearing.

Comment 3

Mr. Scott White from State Farm Insurance, the largest insurer of homes in Tennessee, spoke urging the adoption of the 2017 NEC without amendment. Mr. White noted that TN is the sixth (6th) in the nation for civilian structure fire fatalities, which is about twice the national average. Mr. White additionally noted that the NEC is a minimum standard that has been well-vetted with input from many interests throughout the nation. State Farm feels that adopting a modern electrical code will help save lives and protect property.

Response 3

The Department thanks Mr. White for his comments and for participating in the hearing.

Comment 4

Mr. Ron Bethea, Chief Electrical Inspector for Memphis and Shelby County Codes Enforcement, urged adoption and full implementation of the 2017 NEC. Mr. Bethea noted that more and more electronic devices are being brought into homes now, that electrical systems in homes are becoming more complicated while the number of skilled electricians available continues to decline. Mr. Bethea concludes that it's even more important to leverage technological advancements to protect residential wiring systems. Mr. Bethea explained the technical benefits of the AFCI. Finally, Mr. Bethea also requested the amendment limiting the number of outlets on a circuit be eliminated, which would lessen the cost of full implementation of AFCIs.

Response 4

The Department thanks Mr. Bethea for his comments and for participating in the hearing.

Comment 5

Mr. Keith Stager, resident of Franklin, TN, spoke in support of full implementation of the 2017 NEC. Mr. Stager noted that he has participated at national NFPA conferences and has seen how all parties are able to participate in the drafting process and during the code review process. Mr. Stager concluded by saying that full adoption of the 2017 NEC would be in the best interest of the citizens of Tennessee.

Response 5

The Department thanks Mr. Stager for his comments and for participating in the hearing.

Comment 6

Mr. Dennis Epperson, President of the Home Builders Association of Tennessee and a builder from Cleveland, spoke against the full implementation of the 2017 NEC as it related to AFCIs. Mr. Epperson

said the AFCI isn't justified because it cannot stop an arc from occurring, but can only mitigate it. Mr. Epperson estimated the cost of implementation between $1,000 and $2,000 per home. Mr. Epperson cited the callbacks as a problem with AFCIs and then stated that most homes that burn are older than 20 years.

Response 6

The Department thanks Mr. Epperson for his comments and for participating in the hearing but respectfully disagrees with his assessment. Mitigating an arc is a safety benefit if it prevents an electrical fire from igniting.

Comment 7

Ms. Charlotte Peak, a home builder from Cleveland, spoke against the full implementation of the AFCI. Ms. Peak also stated that AFCIs can only mitigate arc potential effects and do not detect ground faults. Ms. Peak pointed to a number of reports from the U.S. Commercial Product Safety Commission before the 1999 version of the NEC was adopted saying that the benefits of the technology were overblown. Ms. Peak noted that the 2012 report clarified some of the data but said that it included single-family and multi-family dwellings, mobile homes and motor homes. Ms. Peak reiterated that most fires occur in homes that are more than 20 years old and that since 1999, changes in codes and product safety standards mitigate against fire in newer homes even as they age. Ms. Peak did note that electrical issues have become an increasing larger player in residential fires, which was reported by the U.S. Fire Administration in 2016. Ms. Peak explained that older homes were wired with fewer receptacles, which caused homeowners to overload those outlets. Ms. Peak concluded her statement noting that the primary reason for house fires in Tennessee is grease fires in the kitchens and suggested that the Department remove all frying pans in the kitchens.

Response 6

The Department thanks Ms. Peak for her comments and for participating in the hearing but respectfully disagrees with her assessment. Mitigating an arc is a safety benefit if it prevents an electrical fire from igniting, and that information presented at the hearing demonstrates clearly that new and old homes do burn. Finally, the Department recognizes that kitchen fires do cause a significant amount of property damage in Tennessee, but the Department believes that removing all frying pans from kitchens in Tennessee is not a reasonable regulation.

Comment 7

Ms. Susan **Ritter**, Executive Vice President for the Home Builders Association of Tennessee, spoke against full implementation of the 2017 NEC. Ms. **Ritter** noted that the reliability of the AFCIs are bleak and that callbacks are numerous. Ms. **Ritter** reported that new appliances trip the AFCIs, which can ruin the contents of a refrigerator or freezer. Ms. **Ritter** also noted that South Dakota exempted life support equipment from AFCI requirements. Ms. **Ritter** estimated that the cost of implementing the full AFCI requirement would be $1,000 to $3,000 for new homes, but that new homes are already safe without AFCI protection. Ms. **Ritter** stated that for every $1,000 increase in the cost of a home, 4,296 homeowners will no longer qualify for a mortgage.

Response 7

The Department thanks Ms. **Ritter** for her comments and for participating in the hearing but respectfully disagrees with her assessment. The Homebuilders have been unable to provide data relating to nuisance callbacks, only anecdotal accounts, which is not reliable. Further, the claim that an increase in $1,000

prevents 4,296 homeowners from qualifying for a mortgage is an economic development concern, which is best addressed by the General Assembly, THDA and the Department of Economic and Community Development. The Department of Commerce and Insurance is charged with establishing minimal safety standards.

Comment 8

Mr. Don Glays, Executive Director of the West Tennessee Home Builders Association, conferred with association members and codes inspections officials from Memphis, Shelby County, Bartlett and Collierville, and they request the removal of the Tenn. Comp. R. & Regs 0780-02-01-.11(10) limiting the number of outlets on a circuit. Mr. Glays stated that appliances have become more efficient over the years and those appliances are used less often at the same time.

Response 8

The Department thanks Mr. Glays for his comments and for participating in the hearing.

Comment 9

Mr. David Windrow, Deputy Chief of Operations with Brentwood Fire and Rescue, spoke on behalf of the more than 500 members of the Tennessee Fire Chief's Association who support adopting the 2017 NEC without amendments. Mr. Windrow noted that amendments make the codes enforcement more difficult for inspectors and weaken the safety measures included in the standards, which were created by consensus process. Mr. Windrow noted that they are concerned with protecting lives of Tennesseans, but also with protecting the firefighters who go into the homes. Mr. Windrow also noted that in his jurisdiction (Spring Hill, Franklin and Brentwood), they respond to fires at homes that are new builds, and not just old homes. Additionally, Mr. Windrow said that while there are things that we cannot control, we should take action to prevent things we can. The first two known causes of fires in homes are cooking and smoking- things the fire services cannot directly control. But, Mr. Windrow noted, the Department can control the building standards and code adoption. Ten people died in Memphis last year because of a malfunctioning air conditioning unit, which Mr. Windrow stated should be a litmus test for this code adoption. Finally, Mr. Windrow stated that the position of the Association is that the code should be adopted without amendment.

Response 9

The Department thanks Mr. Windrow for his comments and for participating in the hearing.

Comment 10

Mr. Randy Safer, Southern Regional Director for the National Fire Protection Association, spoke in favor of adopting 2017 NEC without amendment. Mr. Safer noted that cooking is the number one cause of fires in Tennessee but not the number one cause of fire deaths. Most fire deaths occur at night while people are sleeping, and many are from electrical malfunctions. Further, Mr. Safer noted that a new home in Tennessee is built to electrical standards that are ten (10) years old though most people looking to buy new homes assume the new home is built to a current safety standard. Mr. Safer acknowledged that new homes are beautiful, but he also noted that new homes do burn and they burn faster. With open floor plans and changes in building materials, flames spread faster, which is a danger to homeowners and firefighters. Given that increased risk to life, Mr. Safer urged adoption of 2017 NEC without amendment.

Response 10

The Department thanks Mr. Safer for his comments and for participating in the hearing.

Comment 11

Mr. Pankay Lal with Schneider Electric spoke to support adoption of the 2017 NEC without amendment. Mr. Lal testified that AFCIs can help stop a fire before it starts. He noted that fire alarms are beneficial to homeowners, but they trigger an alarm after sensing smoke in the home. The AFCI can help prevent the fire before it occurs, and it's usually protecting against something hidden behind the wall that homeowners cannot see. As to cost, Mr. Lal reported that, after installation, AFCIs will cost between 0.01-0.025 percent of the total cost of the home depending on size and number of circuits. As to the technology, Mr. Lal noted that troubleshooting is a feature provided by all the manufacturers, and nuisance tripping rarely occurs. According to Schneider's data, neither is significant enough to stop adoption of AFCIs. Mr. Lal noted that AFCIs can help stop fires like airbags prevent injury from car wrecks.

Response 11

The Department thanks Mr. Lal for his comments and for participating in the hearing.

Comment 12

Mr. Andrew Pieri, Director of Development with City of Portland, requested clarification in the rules regarding who can conduct electrical inspections and requested an increase in the five dollar ($5.00) issuing agent fee to ten dollars ($10.00) since it does not cover current expenses.

Response 12

The Department thanks Mr. Pieri for his comments and for participating in the hearing, but the Department does not plan on requesting a change in the fee at this time.

Comment 13

Mr. Andrew Lee requested adoption of 2017 NEC without amendment. Mr. Lee noted that the extra cost of the AFCI isn't what is primarily driving up the cost of the construction and asked what the cost would be of losing a loved one in a fire, the ongoing hospitalizations and surgeries for burn victims injured in a fire. With the current construction boom, Mr. Lee noted that people rely on legislation and rules to ensure highest safety standards. Mr. Lee reiterated that electrical fires are in the top three causes of fires and that bringing electrical codes to current standards and the expanded use of AFCIs will help lower that number. If proven technology exists to stop fires, Mr. Lee stated that technology needs to be required, not listed as optional.

Response 13

The Department thanks Mr. Lee for his comments and for participating in the hearing.

Comment 14

Mr. Randy Dollar from Siemens addressed the reliability of the AFCI technology. Mr. Dollar noted that nuisance tripping is usually only raised as an issue during codes adoption discussions and that Siemens does

track nuisance calls and maintains state-specific date. For Tennessee in the last year, Mr. Dollar testified that Siemens received four (4) calls and only one (1) was a nuisance call. Two (2) of the complaints were a result of faulty installation/wiring in the house and the last call was a noise issue, not a safety issue, and was resolved. Mr. Dollar also addressed the cost of AFCI and encouraged parties to look at the information readily available online, and using that information, Mr. Dollar calculated the cost overestimating minimum circuits in a house and calculated that the cost would be less than one dollar ($1.00) a month over the life of the mortgage. Additionally, Mr. Dollar noted that the Building Code Effectiveness Grading Schedule is used to evaluate each state and municipality, which affects homeowners' insurance rates. Mr. Dollar testified that two of the questions the Schedule asks is "does your community adopt and enforce the latest edition of nationally recognized codes?" and "are the codes amended to weaken the requirements of the nationally recognized code?" Mr. Dollar noted that adopting 2017 with no amendments will help homeowners' insurance rates.

Response 14

The Department thanks Mr. Dollar for his comments and for participating in the hearing.

Comment 15

Mr. Chris Finen, licensed engineer with the Eaton Corporation, spoke in favor of adopting the 2017 edition of the NEC without amendments. Mr. Finen noted that AFCIs are not new devices; the devices are in their third decade of manufacture, and nuisance tripping has been almost entirely eliminated. Mr. Finen pleaded against reducing the protection AFCIs can offer because of the remaining but minimal nuisance tripping. Finally, Mr. Fine asked the State Fire Marshal not to ignore the opinions of the fire experts like Consumer Protection Safety Commission, Underwriters Lab, United States Fire Administration, Electrical Safety Foundation International, National Association of State Fire Marshals, and others who endorse 2017 NEC without amendment.

Response 15

The Department thanks Mr. Finen for his comments and for participating in the hearing.

Comment 16

Ms. Susan Newman Scarce spoke as a homeowner, mother, grandmother, representative of International Association of Electrical Inspectors and a panel member for the NEC urging adoption of the 2017 NEC without amendment. Ms. Scarce testified that the current electrical standard is almost ten (10) years old. Ms. Scarce explained that the codes require worldwide communication are minimum standards and that lessening the standards is an injustice to the citizens of the state. Ms. Scarce testified that new homes do burn because they are not built to current standards. Ms. Scarce noted that if Tennessee maintains the current adopted standard, that standard is really the 2002 standard regarding AFCI protection, which is different from GFCI. Ms. Scarce rhetorically asked that if the electrical standards go back to 2002, will everything including the electronics we use and the price of our new homes also revert to 2002 standards? Further, Ms. Scarce testified that if there is a problem with nuisance tripping, the statistics don't show it.

Response 16

The Department thanks Ms. Scarce for her comments and for participating in the hearing.

Comment 17

Mr. Felician Arriaga spoke requesting that the Department maintain the current AFCI standard. Mr. Arriaga testified that the homebuilders would pass the increased cost off to the electricians. Ms. Arriaga also asked that the Department provide a document to distinguish the different code adoptions across jurisdictions.

Response 17

The Department thanks Mr. Arriaga for his comments and for participating in the hearing.

Comment 18

Ms. Jean Joseph, a burn victim and resident of New Orleans, submitted a written comment supporting adoption of 2017 NEC without amendment. Ms. Joseph suffered 2nd, 3rd, and 4th degree burns over 50% of her body after a FEMA trailer exploded in August 2006. Ms. Joseph urged Tennessee to adopt safety standards that are consistent with the standards adopted in other states.

Response 18

The Department thanks Ms. Joseph for her comments.

Comment 19

Ms. Nicole Acton submitted a written comment supporting the adoption of the 2017 NEC with full AFCI protection. Ms. Acton's mother is a burn victim, and Ms. Acton wrote of the lifelong impact of a burn injury. Ms. Acton noted that AFCI's prevent arcing that can cause electrical fires and prevents the damage before it occurs. Ms. Acton noted that the AFCIs protect families and children in Tennessee and their implementation should be expanded.

Response 19

The Department thanks Ms. Acton for her comments.

Comment 20

Mr. Brian Holland with the National Electrical Manufacturers Association (NEMA) wrote to urge adoption of the 2017 NEC without amendment. Mr. Holland testified that current code ensures compatibility with electrical product safety standards, manufacturer's installation instructions, and other installation guidelines that impact electrical products. The complete set of rules creates a system of protection and by amending out any one requirement, that system is substantially compromised. Mr. Holland suggested that the decision makers think of the NEC as an automobile. The seatbelts, air bags, and antilock brakes all work together to reduce crashes and to save lives. Mr. Holland noted that if any one of those life safety products is removed, traffic deaths are certain to rise. Mr. Holland noted that as reported in a previous hearing, Tennessee is averaging 11 deaths per 1,000 fires which is twice the national average. 77% of the fire related deaths have occurred in residential structures. According to Mr. Holland, the Consumer Product Safety Commission (CPSC) estimates that approximately 50% of the residential electrical fires that occur each year in the United States could have been prevented by AFCI protection. NEMA strongly urges the Department to keep the 2017 NEC requirements for AFCI protection intact, with no amendments.

Response 20

The Department thanks Mr. Holland for his comments.

Comment 21

Mr. Gary Loftis, professional engineer, wrote to urge adopting the 2017 NEC. Mr Loftis also requested that the Department include amended language regarding boat docks and marinas to clarify existing requirements and to reduce redundancies.

Response 21

The Department thanks Mr. Loftis for his comments.

Comment 22

Ms. Patricia Pennington, licensed general contractor from Cleveland, wrote urging adoption of the 2017 NEC with the amendment to make AFCI optional in all rooms except the bedroom.

Response 22

The Department thanks Ms. Pennington for her comments.

Comment 23

Mr. Paul Rice wrote to the department urging amending the 2017 NEC to require AFCIs in bedrooms and optional in all other rooms. Mr. Rice also submitted an unsigned/unattributed White Paper for the Department's review and the letter from the Home Builders Association of Tennessee signed by Ms. **Ritter** and Mr. Epperson.

Response 23

The Department thanks Mr. Rice for his comments.

Comment 24

Ms. Ashley Rutledge submitted a comment through Representative Rusty Crowe urging adoption of the 2017 NEC without amendment. Ms. Rutledge's letter addresses the cost of the device noting that the devices adds less than $1 a month over the life of the mortgage. Ms. Rutledge also notes that some say nuisance calls are a problem, but Ms. Rutledge writes that the data does not support that claim. Ms. Rutledge also noted that the 2017 NEC was vetted over a 3 year process and that the standards established therein are considered necessary for safety.

Response 24

The Department thanks Ms. Rutledge for her comments.

Comment 25

Mr. Jeffrey Sargent with the National Fire Protection Association (NFPA) wrote to urge the adoption of the 2017 NEC without amendment. Mr. Sargent noted that the 2008 NEC is a sound standard but that the advancements in the electrical industry have outpaced the 2008 code making Tennessee about a decade behind. According to Mr. Sargent, the 2017 NEC contains new requirements that reflect current technology and provides for better materials and methods for electrical installations. Mr. Sargent also noted that the changes in the code create cost savings for consumers, even when compared to the 2014 NEC.

Response 25

The Department thanks Mr. Sargent for his comments.

Comment 26

Ms. Misty Patterson, President of the Clarksville Home Builders Association, wrote urging the adoption of the 2017 NEC with amendment to make AFCI mandatory in bedrooms and optional in all other rooms.

Response 26

The Department thanks Ms. Patterson for her comments.

Comment 27

Mr. Cesar Escarcega, Plant Manager at Eaton, wrote urging the adoption of the 2017 NEC and maintaining the AFCI requirement throughout the home. Mr. Escarcega noted that Eaton, which employs almost 500 people in Tennessee and about 250 in the Cleveland plant, is a world leader in the development, manufacture and sale of electrical products. Mr. Escarcega noted that the AFCI expansion to other rooms in the home will help prevent electrical fires and can save lives. Mr. Escarcega indicated that the cost of the AFCI has been overstated and that nuisance issues are usually the result of faulty wiring.

Response 27

The Department thanks Mr. Escarcega for his comments.

Comment 28

Ms. Susan **Ritter**, on behalf of the Home Builders Association of Tennessee, submitted an amended statement requesting adoption of the 2017 NEC allowing AFCI throughout the house but requested that bathrooms, laundry rooms, garages, unfinished basements and kitchens be exempt from AFCI requirements.

Response 28

The Department thanks the Home Builders Association for its amended comments.

Comment 29

Mr. Daniel P. Johnson, President of the Tennessee Fire Safety Inspectors Association, submitted a comment to support adoption of the 2017 NEC without amendment. Mr. Johnson wrote that the inspectors work

very hard to make sure adopted codes are enforced to ensure the safety of Tennesseans but that homes built to standards a decade old should be troubling to citizens. Mr. Johnson noted that 2016 marked the highest number of fire fatalities in Tennessee in 6 years- 113. As of September 1, 2017, 59 fire deaths had been reported. Mr. Johnson wrote that seatbelts, airbags and smart driver technologies are used every day to reduce accidents in cars, and that there are similar technological improvements in home building, including GFCI and AFCI. These devices have helped reduce electrical fires, electrocution and provide advanced alerts and warnings. As fire safety inspectors, Mr. Johnson writes that they see from the front lines what AFCIs can do to prevent electrical fires. The devices have provided protection in bedrooms and that protection should be expanded into the kitchen and laundry areas where increasing amounts of electrical use (charging stations and corded appliance use) occurs.

Response 29

The Department thanks Mr. Johnson for his comments.

Regulatory Flexibility Addendum

Pursuant to T.C.A. §§ 4-5-401 through 4-5-404, prior to initiating the rule making process, all agencies shall conduct a review of whether a proposed rule or rule affects small business.

The Department has considered whether these rules will have an economic impact on small businesses (those with 50 or fewer employees). These rules govern electrical installations in Tennessee in commercial and residential properties and for boat docks and marinas. Because of the scope of the rules, small businesses will likely be impacted.

1. The type or types of small businesses and an identification and estimate of the number of small businesses subject to the proposed rule that will bear the cost of, or directly benefit from the proposed rule:

The Board for Licensing Contractors reported that 6,320 residential building contractors are licensed in Tennessee, but it cannot determine which ones are small businesses. The Board has also licensed approximately 10,000 limited licensed electricians. The rule addresses code adoption and clarifies when inspections are made. The rule alone imposes no additional costs. Owners of new homes built to a modern and current electrical code will directly benefit from the adoption of updated codes.

2. The projected reporting, recordkeeping and other administrative costs required for compliance with the proposed rule, including the type of professional skills necessary for preparation of the report or record;

The rule requires no additional reporting, recordkeeping or administrative compliance.

3. A statement of the probable effect on impacted small businesses and consumers;

The probable effect cannot be determined as the code allows for alternative cost-saving methods.

It is not, however, anticipated to have a greater impact than current standards.

4. A description of any less burdensome, less intrusive or less costly alternative methods of achieving the purpose and objectives of the proposed rule that may exist, and to what extent the alternative means might be less burdensome to small business;

There are no less burdensome methods for achieving the purpose of the proposed rule.

5. A comparison of the proposed rule with any federal or state counterparts; and

There is no federal counterpart.

Following is a list of state counterparts as of November 2017:

2017 NEC: 12 states; TX, CO, ID, MA, MN, NE, ND, OR, SD, VT, WA, WY

2014 NEC: 25 states; AL, AR (moving to 2017 NEC in December 2017), GA (moving to 2017 NEC in early 2018), KY (moving to 2017 NEC in early 2018), NC, OK, SC, WV, AK, CA, CT, DE, HI, IA, ME, MD, MI, MT, NH, NJ, NM, NY, OH, RI, UT

2011 NEC: 4 states; FL, LA, VA, WI

2008 NEC: 3 states; IN, PA, TN

No statewide NEC: 6 states; AZ, IL, KS, MS, MO, NV

6. Analysis of the effect of the possible exemption of small businesses from all or any part of the requirements contained in the proposed rule.

The Department establishes the minimum electrical standard across the state for the protection of life and property. Exempting small businesses from minimum safety standards would undermine the purpose of the proposed rule and the statutory obligation of the Department of Commerce and Insurance, Division of Fire Prevention.

Impact on Local Governments

Pursuant to T.C.A. §§ 4-5-220 and 4-5-228 "any rule proposed to be promulgated shall state in a simple declarative sentence, without additional comments on the merits of the policy of the rules or regulation, whether the rule or regulation may have a projected impact on local governments." (See Public Chapter Number 1070 (http://publications.tnsosfiles.com/acts/106/pub/pc1070.pdf) of the 2010 Session of the General Assembly)

The rule proposed may have a projected impact on local governments.

Additional Information Required by Joint Government Operations Committee

All agencies, upon filing a rule, must also submit the following pursuant to T.C.A. § 4-5-226(i)(1).

(A) A brief summary of the rule and a description of all relevant changes in previous regulations effectuated by such rule;

The amendments to Tenn. Comp. R. & Regs. 0780-02-01-.02 [Adoption by Reference] adopts the 2017 edition of the NEC to become effective July 1, 2018. The rule also makes arc fault circuit interrupters (AFCI) optional in bathrooms, laundry areas, garages, unfinished basements as defined in NEC and for branch

circuits dedicated to supplying refrigeration equipment. Finally, the rule allows utility companies to make AFCI optional under Section 110.24.

The amendments to Tenn. Comp. R. & Regs. 0780-02-01-.04 [Inspections] include correction of citations and terminology. The substantive changes will allow deputy fire marshals to perform electrical inspections where the need arises, so long as they are properly certified. Furthermore, the amendments provide that an inspection will be required on the re-connections of electrical power to a building and for temporary service poles. Additionally, supplying of electrical power for final inspections will be required in residential and commercial buildings in which the electrical power has been disconnected. The amendments also add the requirement that all signs receiving electrical power shall be inspected.

The amendments to Tenn. Comp. R. & Regs. 0780-02-01-.05 [Permits] clarify that the permit application fee of five dollars ($5.00) is in addition to all other required inspection fees. Another change will delete language related to the electrician registration program, which is no longer in effect through the Division of Fire Prevention. This registration program is currently handled by the Tennessee Board for Licensing Contractors.

The amendments to Tenn. Comp. R. & Regs. 0780-02-01-.11 [Dwelling Units] are related to the electrical standards applicable to dwelling units. Paragraph (2) addressing lighting in clothes closets is deleted entirely. The section is irrelevant in light of the language in the 2017 edition of the NEC. The amendments to Paragraph (4) relate to smoke alarm requirements for newly constructed one and two family dwellings. The amendments reflect the statutory changes made in T. C. A. § 68-102-151. The primary changes in this paragraph clarify that the statute is applicable to newly constructed homes and changes the term smoke detector to smoke alarm, which is more commonly used in the industry. Additionally, the rule clarifies smoke alarms must be installed in accordance with building standards adopted by the State Fire Marshal pursuant to Tenn. Code Ann. § 68-120-101 rather than the 2003 International Residential Code.

The most substantive statutory change to the smoke alarm section is the removal of the previous exemption which exempted a one family dwelling unit built and occupied by the family from the smoke alarm requirements. Paragraph (8) was added to the rule to clarify that light fixtures in crawl spaces of dwelling units shall have guarded covers and is identical to the requirement for the installation of HVAC units in Tenn. Comp. R. & Regs. 0780-02-01-.13. The 2017 NEC addresses the requirements in paragraph (10), making it unnecessary, and the amendment deletes paragraph (10) entirely.

The amendment to Tenn. Comp. R. & Regs. 0780-02-01-.15 [Used Manufactured Homes] reflects the adoption of the 2017 NEC.

The amendment to Tenn. Comp. R. & Regs. 0780-02-01-.20 [Local Government Authorization to Perform Electrical Inspections] clarifies that the State retains jurisdiction for electrical inspections over state owned and state leased buildings in jurisdictions where local governments have been authorized to conduct electrical inspections.

The amendment to Tenn. Comp. R. & Regs. 0780-02-01-.22 [Boat Docks and Marinas] clarifies the appropriate section of the NEC to be used when the time of the installation cannot be determined. Additionally, the rules add language permitting voltage in yard and pier distributions systems to exceed the maximum voltage specified in the NEC if written documentation is submitted from a licensed engineer.

(B) A citation to and brief description of any federal law or regulation or any state law or regulation mandating promulgation of such rule or establishing guidelines relevant thereto;

TCA § 68-102-113, which requires the state fire marshal to establish minimum electrical standards; § 68-102-143, which allows the Commissioner to appoint deputies to perform electrical inspections; and § 68-102-603, which gives the Department jurisdiction to conduct inspections of commercial marinas.

(C) Identification of persons, organizations, corporations or governmental entities most directly affected by this rule, and whether those persons, organizations, corporations or governmental entities urge adoption or rejection of this rule;

Electrical Inspectors: No position taken

Local Jurisdictions with exempt status: No position taken

Licensed electricians: No position taken

Insurance companies: State Farm is on record urging adoption of 2017 NEC without amendment

Homebuilders: Urge adoption on all points except the AFCI requirement throughout the kitchen

Fire Service: Urge adoption of 2017 NEC without amendment

Burn Victims: Urge adoption of 2017 NEC without amendment

Manufacturers: Urge adoption of 2017 NEC without amendment

IAEA, NFPA, NEMA: Urge adoption of 2017 NEC without amendment

(D) Identification of any opinions of the attorney general and reporter or any judicial ruling that directly relates to the rule or the necessity to promulgate the rule;

Attorney General Opinion No. 99-148.

(E) An estimate of the probable increase or decrease in state and local government revenues and expenditures, if any, resulting from the promulgation of this rule, and assumptions and reasoning upon which the estimate is based. An agency shall not state that the fiscal impact is minimal if the fiscal impact is more than two percent (2%) of the agency's annual budget or five hundred thousand dollars ($500,000), whichever is less;

The Department anticipates no change in state or local government revenues or expenditures.

(F) Identification of the appropriate agency representative or representatives, possessing substantial knowledge and understanding of the rule;

Gary Farley, Director of Fire Prevention Inspections and Permits & Licensing Section

Mary Beth Gribble, Director of Programs and Policy Development

(G) Identification of the appropriate agency representative or representatives who will explain the rule at a scheduled meeting of the committees;

Gary Farley, Director of Fire Prevention Inspections and Permits & Licensing Section

Mary Beth Gribble, Director of Programs and Policy Development

Leigh Ferguson, Chief Counsel for Fire Prevention and Law Enforcement

(H) Office address, telephone number, and email address of the agency representative or representatives who will explain the rule at a scheduled meeting of the committees; and

Department of Commerce and Insurance

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Mary Beth Gribble, 615-532-3272, marybeth.gribble@tn.gov

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(I) Any additional information relevant to the rule proposed for continuation that the committee requests.

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